CAN A WEAKER DOLLAR BE AN ANTIDOTE FOR EM?

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03/21/2023

For most of the last two years, the dollar steadily strengthened against most major currencies with little interruption. Record inflation in the U.S. prompted the Federal Reserve to embark on its most rapid pace of interest rate hikes that many in our industry have ever seen, and the dollar followed suit. It peaked in late 2022, more than two standard deviations above its median price over the past three years.

Bloomberg U.S. Dollar Spot Index

Sources: WisdomTree, Bloomberg, as of 3/6/23. Past performance is not indicative of future results. You cannot invest directly in an index. Bloomberg U.S. Dollar Spot Index: tracks the performance of a basket of 10 leading global currencies versus the U.S. Dollar.

While higher rates extinguished risk appetite for investors and sent the dollar soaring, emerging market (EM) equities continued their downtrend. Although the region caught a brief reprieve when China announced the end of its "Zero Covid" policy last fall, providing renewed optimism for the region's largest growth engine, EM remains hamstrung by the U.S. economic and policy landscape and their attendant effects on the dollar.

Recently, the dollar has slipped from last year's highs but remains elevated compared to recent history, as U.S. economic data continues to surprise to the upside, complicating the future path of monetary policy for the Fed.

To be clear, however, we're not dollar bearish. The early 2023 economic data and commentary from Fed officials imply that more rate hikes are virtually certain over the near term to temper the stubbornly resilient U.S. economy.

Our view is that the dollar may eventually fall closer to a more reasonable level, off last year's highs, as the path of U.S. interest rates becomes clearer. That forces us to consider what assets may benefit most. In this scenario, we think EM may receive a modest tailwind, potentially benefiting from supportive relationship dynamics with the USD.

Correlations Point to EM Upside in a Weak Dollar Environment

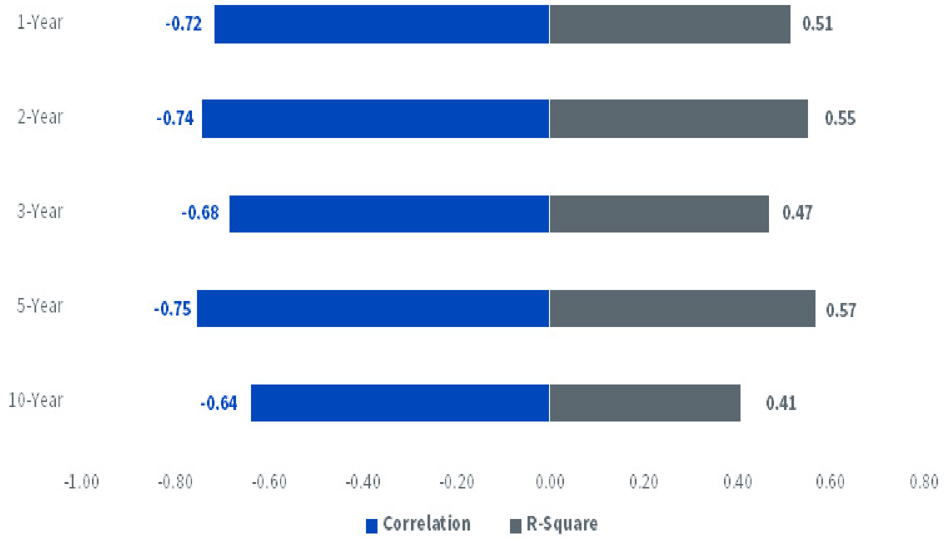
EM equities and the dollar have long displayed an inverse relationship. There are myriad reasons for this, both technical and sentiment-driven.

At a business level, EM companies often borrow in dollars, which creates difficulty in servicing that debt during periods when the U.S. dollar is strong and local currencies are weak, challenging the prospects of businesses themselves.

EM equities are also an explicit barometer of investor risk appetite across global markets. The dollar often tends to rally as a safe haven during risk-off periods when investors sell EM assets to reduce risk exposure.

The magnitude of the inverse correlation suggests that even a slight decline in the dollar can improve EM returns, especially over the short and medium terms.

Rolling Return Relationships - MSCI EM vs. USD



Sources: WisdomTree, Bloomberg, as of 1/31/23. USD returns represented by performance of the Bloomberg U.S. Dollar Spot Index (BBDXY). Correlation and R-square for each period represent those measurements calculated using rolling returns over the common period for each Index. Past performance is not indicative of future results. You cannot invest directly in an index. Subject to change.

Sector Composition May Compound These Effects

Emerging markets resemble a partial hybrid of both the U.S. and developed markets. Sizable footprints in "growthy," consumer-focused areas such as Technology, Communication Services and Consumer Discretionary are reminiscent of the U.S. equity market, while an even larger allocation to Financials resembles a heavyweight from the developed market universe. These four sector concentrations comprised exactly two-thirds of the MSCI Emerging Markets Index over the past five years, on average.

Most notable, however, are their respective relationships to the trajectory of the dollar. Beta and correlation measures over the last several years indicate that each sector tends to move emphatically in the opposite direction of the greenback.[1]

Sector	5-Year Avg. MSCI EM Index Weight	Beta to USD			Correlation to USD		
		1-Year	3-Year	5-Year	1-Year	3-Year	5-Year
Comm. Svcs.	11.5%	-2.20	-1.98	-1.97	-0.68	-0.64	-0.77
Cons. Discretionary	14.1%	-2.80	-1.80	-2.11	-0.65	-0.52	-0.65
Financials	21.7%	-2.15	-1.66	-1.48	-0.57	-0.57	-0.61
Info. Tech.	19.5%	-2.45	-0.58	-0.63	-0.60	-0.18	-0.19

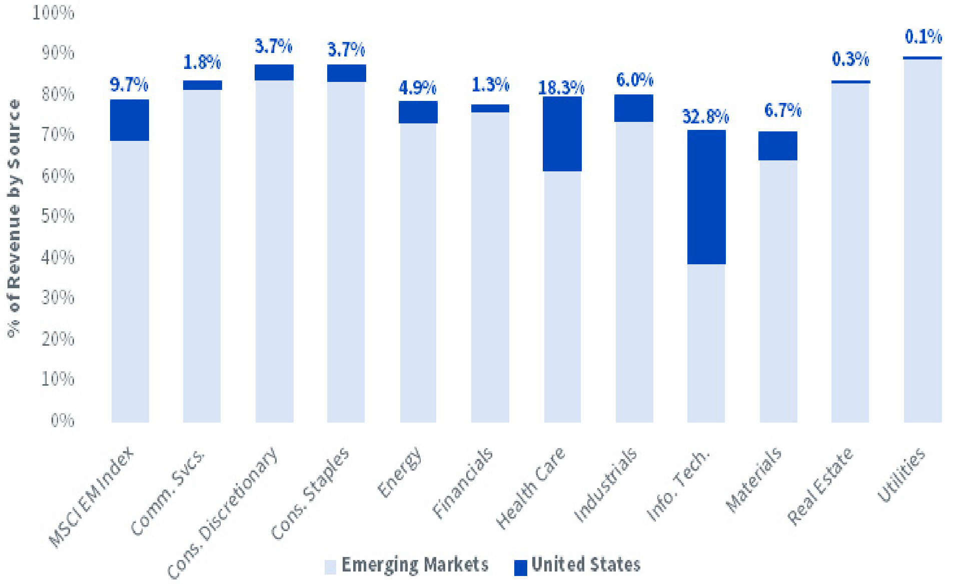
Sources: WisdomTree, Bloomberg, as of 1/31/23. Past performance is not indicative of future results. Subject to change. You cannot invest directly in an index.

This could also benefit the EM region if we see reduced volatility in the dollar.

Weak USD Poses Little Threat to Revenue

Currency fluctuations impact trade competitiveness and relationships, and emerging markets exports are no exception. However, geographic revenue data suggests that although the broader region is globally interconnected, its relationship with the U.S., and therefore the dollar, is less significant.

Geographic Revenue Exposure



Sources: WisdomTree, FactSet, as of 1/31/23. Subject to change. You cannot invest directly in an index.

The headline EM Index only generates about 10% of total revenue from the U.S. market. Excluding Information Technology once again, where the U.S. is a significant consumer, every other sector generates a majority of revenue from within the greater EM region.

This introduces more favorable currency dynamics into the viability of EM as a whole since the region is not beholden to U.S. economic growth or the path of U.S. monetary policy from a revenue standpoint. Instead, regional economic interrelationships and local currency fluctuations may be more deterministic, especially in anticipation of U.S. economic weakness.

EM Assets Would Welcome a Dollar Downtrend

While the surge higher in the dollar last year was at times both a symptom and a cause of investors' agony, the dynamic of its relationship with emerging market equities suggests that even a slight weakening would offer a reprieve. A softening may provide a much-needed tailwind to EM equities without threatening revenue prospects for the region as well since the U.S. is only a modest consumer of EM goods.

As we look further into this year or next year, rate cuts that would reduce the U.S. policy gap with the rest of the world and moderate the dollar could create renewed risk appetite for EM equities.

[1] Information Technology had the least negative beta and correlation of the four sectors mentioned over the 3- and 5-year periods.

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DEFINITIONS

USD (United States Dollar) : The USD (United States dollar) is the official currency of the United States of America. The United States dollar, or U.S. dollar, is made up of 100 cents. It is represented by the symbol $ or US$ to differentiate it from other dollar-based currencies.

Inflation : Characterized by rising price levels.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Standard deviation : measure of how widely an investment or investment strategy’s returns move relative to its average returns for an observed period. A higher value implies more “risk”, in that there is more of a chance the actual return observed is farther away from the average return.

Emerging market : Characterized by greater market access and less potential for operational risks when compared to frontier markets, which leads to a larger base of potentially eligible investors.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Bear market : A sustained downturn in market prices, increasing the chances of negative portfolio returns.

MSCI Emerging Market Index : The MSCI Em (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries.

Volatility : A measure of the dispersion of actual returns around a particular average level. .