From West to East

Weekly Investment View
15th July, 2018

Where currencies go, so do markets — and the dollar is up

Over long periods of time, there is a high correlation between currencies and equity markets. It makes sense: trade can be a big component of any economy and much of how a currency behaves reflects trade. Accordingly, long-term investors should have in mind where foreign exchange rates might be headed.

Last week was the perfect example of how currencies can drive market action. On Tuesday, President Donald Trump indicated his team had drawn up a new US$200 billion list of Chinese products on which to apply higher tariffs. Shortly after the news, the Chinese yuan began to drop and the dollar, to rise.

The yuan has exhibited an unusually high inverse correlation with the dollar index. Over the past two years, when the yuan weakened, the dollar index tended to rise, despite the fact that the dollar index is solely comprised of G-10 currencies such as the euro, the Swedish krone, the Japanese yen and the British pound.

While the dollar index reaction has been unusual, the response of other asset classes to it has been what should have been expected. US Treasury yields dropped as the dollar rose on 11th July, after the new tariffs announcement. That is consistent with a rising dollar, but it is also consistent with the possibility that China is buying US Treasuries to devalue its currency.

Equity markets also suffered, particularly in China, where the falling yuan compounded with news of more tariffs. The CSI 300 index dropped 1.7% on Wednesday, while the broader MSCI Asia Ex-Japan index was down 1.1%.

Commodity-exporting countries were the hardest hit, with the Australian and New Zealand dollar leading the pack downward. That is a function of China's reaction to US tariffs. About a tenth of US exports to China are soft commodities. It is natural, therefore, that China targets soybeans, pork, cotton and other products it buys from the US.

"Once China stops buying their commodities, American farmers will turn elsewhere to sell and may depress global prices."

Indeed, in the past month, since the trade war escalated and the yuan weakened – which both coincided with talks of China reducing purchases of these commodities from the US – the Bloomberg Agriculture Commodities index has dropped 10.9%. That index fell 2.4% on Wednesday alone.

Again, part of it can be attributed to a rising dollar, but the greenback has only appreciated by half a percentage point in the same period. The yuan, meanwhile, dropped 4.1%. Clearly, it is China driving soft commodity prices down.

That may be a problem for commodities exporters far beyond Australia and New Zealand. Brazil and Argentina, for instance, may have benefited from Chinese restrictions on American soybeans as they are the next biggest exporters. The advantage, however, has been erased by the 10% drop in the commodity price over the past month.

Late Wednesday, however, China's Vice -Minister of Commerce, Wang Shouwen, said that if the US and China have a trade problem they "should talk about it." That single line, together with a slight shift in rhetoric, was enough to reverse some of Wednesday's moves, and Asian stocks rallied along with the yuan as Treasury yields increased by 1.5 basis points. Soft commodities rallied 0.4%.

Even before Wang's comment there were already indications the Chinese were capitulating. On Tuesday, while the yuan weakened, the People's Bank of China had set the fix toward the lower part of the daily band, indicating they were hoping for an appreciation bias. That means China may be feeling the side-effects of the rapid plunge of its currency. The last time the yuan moved so sharply, it took China almost two years and some US$1 trillion in reserves to stabilize it as well as its local stock markets. The intent was also apparent in the rise of the local stock indices, driven by large state-owned companies, a similar pattern to the period in 2015 and 2016 when the government nudged the indices higher.

Yet, for all the talk and actions, the yuan has continued to weaken, and was down 0.73% for the whole of last week, while the dollar index rose 0.76%.

Again, emerging market currencies are the worst hit in this process. India, for instance, has been in the eye of the storm. The rupee had already hit a record low this month, though it recovered 0.51% last week, buoyed by the sudden risk-on attitude of investors on Thursday and Friday.

The gains may be fleeting. On Friday, government data showed that the country's trade deficit rose to US$16.6 billion in June, the highest monthly figure in five years. The biggest culprit, yet again, was oil, as the value of imports of the commodity rose 57% year-on-year. Much of the increase was attributed to a 66% increase in the price of the commodity between 30th June, 2017, and the same date this year.

In spite of that, consumer inflation slowed down to 5.0% in June from 5.3% in May. That is good news as the biggest threat oil prices pose to India's economy is inflation, which has already pushed the Reserve Bank of India to increase rates unexpectedly once this year. Otherwise, India is a domestically-driven economy — exports account for less than a fifth of GDP. If inflation and consumers' pockets are less impacted by oil prices, the country could probably navigate global rising rates better than many others.

"After the dollar and US interest rates stabilize, EM are likely to continue driving global growth."

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First, however, there will be an adjustment, and that is true for all emerging markets. The MSCI Emerging Market Currency index is down 2.9% this year as the dollar has strengthened. The MSCI Emerging Markets equity index, meanwhile, is down 7.2% over the same period. The currency index had rallied 11.4% last year and the equity benchmark closed 2017 up by 35%. Hence, the move so far can be considered a correction. The downside from here, however, seems much smaller, although returns in the short -run are still skewed to losses.

Key to the short-term direction of emerging markets will be the path of interest rates in the US. The Federal Reserve has indicated it may increase rates twice more this year and as many as three more times after that before pausing. The US economy remains strong enough to warrant that, a fact Fed Chairman Jerome Powell restated in an interview last week. However, the rising dollar may pose a conundrum for the central bank: it curbs inflation and slows the economy, so it could prompt the Fed to change its rate hike plans.

Markets are betting the change is impending. Implied forwards have discounted to near-zero the possibility of any interest rate hikes in 2020 and indicate slim chances of two more increases this year. The difference in yield between two- and 10-year US Treasuries is at its smallest since 2007, a sign that investors expect a recession ahead. In that sense, investors will be closely watching the September Federal Reserve meeting.

"If the Fed indicates it may slow its interest rate normalisation, it may prompt a rally in risk assets, especially EM, as funds have a lot of cash sitting idle."

In the meantime, Gulf Cooperation Council oil producers are perhaps the brightest spots among developing markets. These countries benefit from higher oil prices and mostly have pegged currencies, unlike most other emerging nations. Plus, there has been a recent awakening among global investors to the importance of these markets, both as a source of diversification, and, in particular, of future growth. Countries in the Middle East mostly have young populations with high birth rates, which bodes well for future growth. Recently, they have also become more inclusive, with Saudi Arabia's permission for women to drive being the poster child of that initiative. The demographic impact of bringing more women into the workforce alone could boost growth.

Furthermore, governments in the GCC have increasingly shifted resources to knowledge-based industries. The UAE's national strategy for innovation, launched at the end of 2014, has created the right environment for large companies in the internet sector to set up operations there. The move has further encouraged others, such as the Kingdom of Bahrain, to establish regulatory guidelines for financial technology too.

Such initiatives play well to the aspirations of the region. With the ability to invest oil riches in the education of a growing pool of young people and a long history of being at the center of interaction among various cultures, the Middle East is perfectly suited to become a center of growth based on trade, finance and technology.

In fact, taking a very long view, prosperity derived from hydrocarbons is not even 100 years old and is but a blip in the history of a region which was at the center of world trade for centuries and gave humanity astronomy, writing, navigation and much of the foundations of mathematics. Western investors seem to be seeing that shift back to the region's natural inclination and expressing it through the inclusion of Saudi Arabia in the MSCI EM index and the indication that Kuwait is likely to be next. That may lead some EM funds to add exposure to the region, though the simple concept of diversification suggests they should have done it a long time ago.

"While most of the emerging market world may suffer from a stronger dollar and rising oil prices, GCC markets react the opposite way."

Indeed, while the MSCI Emerging Market index has had a bad year to date, the S&P Pan Arab Composite Index is up 10.2%, despite a series of hiccups for Dubai stocks which have brought that market to near its cheapest in five years on a forward price-to-earnings ratio basis.

If better growth prospects and cheap valuations were not enough, oil prices appear to be on the rise and continue to drive growth in the region. In the past week, several banks have revised their average price expectations up as a result of that. The FAB Asset Allocation Committee had made that move a few months ago, increasing its expected range for the price of Brent crude in 2018 to US$65-US$90/barrel.

Brent crude did experience a one-day drop of almost 6% on Wednesday, amid news that Libya had been able to restart exports. That move reversed as investors considered the fact that US inventories dropped to their lowest since 2015, Norway's oil workers went on strike, and that Libyan production was threatened by another attack on its largest oil field. For oil prices, the risk remains to the upside as millions of barrels from Iran and Venezuela are withdrawn from the market.

The one area to be careful with in the region, and which is not benefiting from higher oil prices, is Turkey. The lira has lost 21.5% of its value this year. It dropped 5.5% last week alone, after recently elected President Recep Tayyip Erdogan named his son-in-law, Berat Albayrak, as Finance Minister. Erdogan has said Turkey does not need high interest rates and has criticized the central bank for raising them. Again, as goes the currency, so goes the market and the Borsa Istanbul 100 index is down 28.1% this year.

Investment Summary: The S&P 500 ended the week 0.62% higher and is now only 2.6% shy of its all-time high reached in January. The move is consistent with the FAB Asset Allocation Committee's view of a long and sustained growth cycle in the US which has yet to run its course. Similarly, the Nasdaq Composite hit a record last week, closing at 7,825.98. Technology stocks remain favoured by the AAC, based on continued expectations for earnings growth in the region of 16-17% in the medium-term.

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