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MARKET COMMENTARY

Ashmore

What goes around comes around: a short note on Dollar risk

By Jan Dehn

The United States (US) stock market is up nearly 500% since the 2008/2009 financial crisis, including dividends. No other market in the world has done better. US high yield and leveraged loan markets have also done well. The US dollar buys more than 40% more EURs today than in 2008 and about 50% more EM FX.

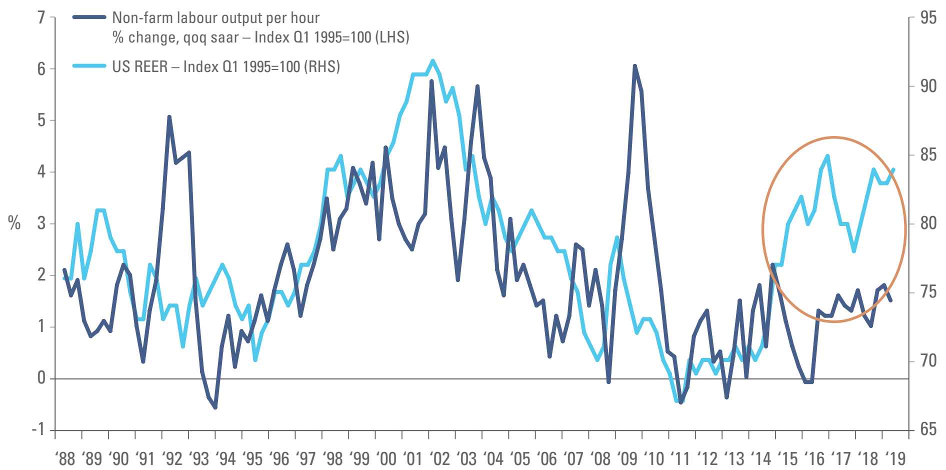
The strong Dollar performance over the last decade can be attributed to flows from other parts of the world into US stock and credit markets. Foreign investors bought Dollars in order to buy these assets and they have benefitted enormously from strong returns as well as currency upside.

US markets are continuing to perform well at the start of 2020, but valuations are frothy, positioning is heavy and, while the US economy does not appear to be on the brink of recession it is nevertheless steadily losing momentum. At times such as these, it is prudent to consider what might happen if and when the tide turns for US markets.

The Dollar last traded this expensive relative to US productivity growth just prior to the collapse of the Dotcom Bubble

The first observation is that US stock and credit markets have done well mainly for cyclical reasons. Stocks rallied on rising earnings on the back of the economic recovery from deep crisis. Capital costs for US corporates have been modest due to the low-rate Quantitative Easing (QE) environment. Wage pressures were low due to high unemployment and low participation rates, among other reasons.[1] Stock prices have been buoyed by share buybacks, which have been financed by curtailing investment in the real economy and a large pro-cyclical tax cut.[2] Structural underpinnings have largely been absent from the rally in US financial assets as evidenced by productivity growth, which has been languishing at low levels since the mid-2000s. The Dollar looks particularly expensive relative to productivity growth as shown in Figure 1. The only time a similar gap has existed was immediately prior to the collapse of the Dotcom Bubble in 2000.

Fig 1: **US productivity growth and the Dollar**



Source: Ashmore, Bloomberg. Data as at 30 September 2019.

The problem with cyclical drivers is that they come to an end! While the US economy does not appear to be about to fall off a cliff, it is displaying symptoms of a late-cycle expansion, including large twin deficits, stronger consumer spending and tight labour markets against a backdrop of weakening investment and earnings, an expensive currency and elevated asset prices. The Fed has begun to cut rates, which is a sign, if any was needed, that the cycle is getting a big long in the tooth. Protectionism is also a classic policy reaction in countries experiencing the type of competitiveness challenges typical of late-stage business cycles.

[1] Most notably high unemployment and low participation rates in the years immediately after 2008/2009 helped to keep wage costs low, although labour-replacing technology and outsourcing of labour intensive jobs to other countries are arguably more structural in nature.
[2] The US government debt stock has increased by nearly 50% of GDP since 2008/2009.

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A slowdown in the US economy, even a gradual one, could prove Dollar negative. The Dollar has fallen modestly against Emerging Markets (EM) currencies in three of the last four years (2016, 2017 and 2019), but gained strongly in 2018 albeit possibly due to special circumstances, such as President Donald Trump's trade war, which reduced EM growth rates and the short-term boost to US growth from the December 2017 tax cut. However, the vast majority of the money that poured into the US from abroad, predicated on a bullish view of the US economy, remains there. Hence, if the US weakens, this money is in the wrong place and could leave.

Foreigners now own 23% of US financial assets, an increase of USD 9.6trn since 2007

The possibility of foreign money leaving the US is sobering given the magnitude of foreign exposure to US markets. Based on the latest available data from mid-2018, foreigners own nearly USD 10trn more US financial assets than they did in 2007. Specifically, foreign holdings of US equities has increased by USD 5.0trn to USD 8.1trn, while foreign holdings of US fixed income has gone up by USD 4.6trn to USD 11.3trn (Figure 3). Foreigners now own USD 19.4trn of US financial assets, which is equivalent to 23% the total and compares to 18% before the 2008/2009 financial crisis.

Fig 2: **Foreign holdings of US financial assets**

	Equities		Fixed income		Total	
	USD trn	% of total	USD trn	% of total	USD trn	% of total
2018	8.1	19%	11.3	26%	19.4	23%
2007	3.1	12%	6.6	23%	9.8	18%
Change	5.0	–	4.6	–	9.6	–

Source: Ashmore, SIFMA, US Treasury. Data as at June 2018.

While the scale of foreign exposure to US markets poses the risk to the Dollar if the US weakens, the problem is made worse by the lack of onshore hedging options. Due to the falling knife problem, the vast majority of foreign investors are unlikely to be able to get out of their exposures to US stocks and credit if markets suddenly fall. Their only onshore hedge is to own Treasuries. However, after many years of QE the yield on US Treasuries is so low that US bonds no longer offer the protection they once did. If foreign investors are unable to hedge in full onshore they are likely to sell the Dollar to offset US losses.

Yields are so low that US Treasuries cannot fully hedge potential losses in stocks and credit if the US slows meaningfully

Figure 3 quantifies the potential size of the required Dollar hedge in the event of a serious US slowdown. The analysis assumes that US stocks fall by 50% with a 10% loss in credit markets, while the yield on the 10-year Treasury bond drops all the way to zero.[3] Given its yield of 1.8% and duration of roughly 9 years, a 10-year Treasury bond will return 16% if the yield drops to zero. With the size of foreigners' exposure to Treasuries, this translates into a positive return of USD 0.9trn. However, the possible losses from US credit and stock markets are likely to be far larger than this, in our opinion. Specifically, the loss in credit markets could be at least USD 0.6bn, given current exposures, while the decline in stocks could wipe out about USD 4.1trn of value. This means that foreign investors face a total projected loss in US markets of about USD 3.8trn net of the return from the hedge in Treasuries if the US slows significantly. This loss is equivalent to 19% of total foreign exposure in US financial markets. In other words, foreigners would require a Dollar hedge of same size, i.e. roughly 20%.

Fig 3: **Projected losses by foreign investors in US markets in the event of recession**

	% loss	USD loss (trn)
Equity markets	50%	-4.1
Credit markets	10%	-0.4
Treasury markets	-16%	0.9
Other fixed income	10%	-0.2
Total		-3.8
Loss as % of total exposure		-19%

Source: Ashmore, SIFMA, US Treasury. Data as at June 2018.

[3] US stocks fell about 85% in the 1930s, 50% in the 1970s, just over 50% in 2000 and just shy of 60% in 2008/2009. Drawdowns in US high yield have ranged from 10% to 30% in the last three recessions. This analysis assumes a 10% drawdown. The default rate for US high yield in downturns ranges from 12% to 14%. The yield on the 10-year Treasury bond typically falls at least 200bps in recessions.

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The initial reaction to a sudden US slowdown in global financial markets is likely to be characterised by the usual rush into so-called safe haven trades, including Dollars, Treasuries, Swiss Franc, Japanese Yen, gold, etc. It is also entirely likely that investors will sell some EM. However, such panic trades are always short-lived and should be ruthlessly exploited to enter into trades, which are likely to perform in the lower Dollar environment that follows the initial panic.[4]

EM markets are extremely well positioned to perform in a lower Dollar environment

Once the move lower in the Dollar takes root, it is likely that flows into EM local markets will pick up sharply. After all, most foreign investors are Dollar-based and highly sensitive to FX losses, so they only consider investments in EM local markets when the Dollar starts to fall.[5]

No other market in the world is better placed to perform in a lower Dollar environment than EM local markets, namely local stocks and bonds. First, these are the only markets in the world yet to receive major dedicated inflows since QE began nearly ten years ago, hence they are cheap in absolute and relative terms with very supportive technicals. Exposure to EM local markets among institutional investors in developed countries is currently 4-6 times lower than a decade ago.

Second, EM economies are severely finance constrained with shares in global financial markets below their GDP share (Figure 4). The existence of binding finance constraints means that flows back to EM are likely to set in motion a virtuous circle within which inflows ease financial conditions, which in turn begets stronger fundamentals, which then justifies further inflows and so on.[6] What goes around comes around.

Fig 4: **Market share versus GDP share: financial conditions by region**

Region	Market share		GDP share (PPP-adjusted)	Ratio of financial markets share to GDP share
	Stocks	Bonds		
Developed Markets	69%	77%	40%	3.6
Emerging Markets	31%	23%	60%	0.9
Africa	1%	1%	5%	0.3

Source: Bloomberg, IMF, Ashmore, MSCI, BIS. Data as at end 2018.

[4] To see the excess return generated by investing in EM specifically in response to bouts of risk aversion see: *'Gee Vix!'*, Weekly investor research, 30 May 2017.

[5] This is not entirely rational, in our opinion. Bonds in EM local markets also pay higher yield than bonds in developed economies, so the return on EM local bonds in Dollar terms in the past four years has been extremely attractive despite the lack of currency upside. Specifically, EM local bonds have returned 11.4% annualised in USD terms over 2016-2019 period compared to just 3.5% for US government bonds with the same duration.

[6] The virtuous circle only ends when inflation returns, but this is likely to be years away given the low inflation rates and spare capacity that currently prevail in most EM economies.

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