

Top dollar no more?

EM equities and the dollar

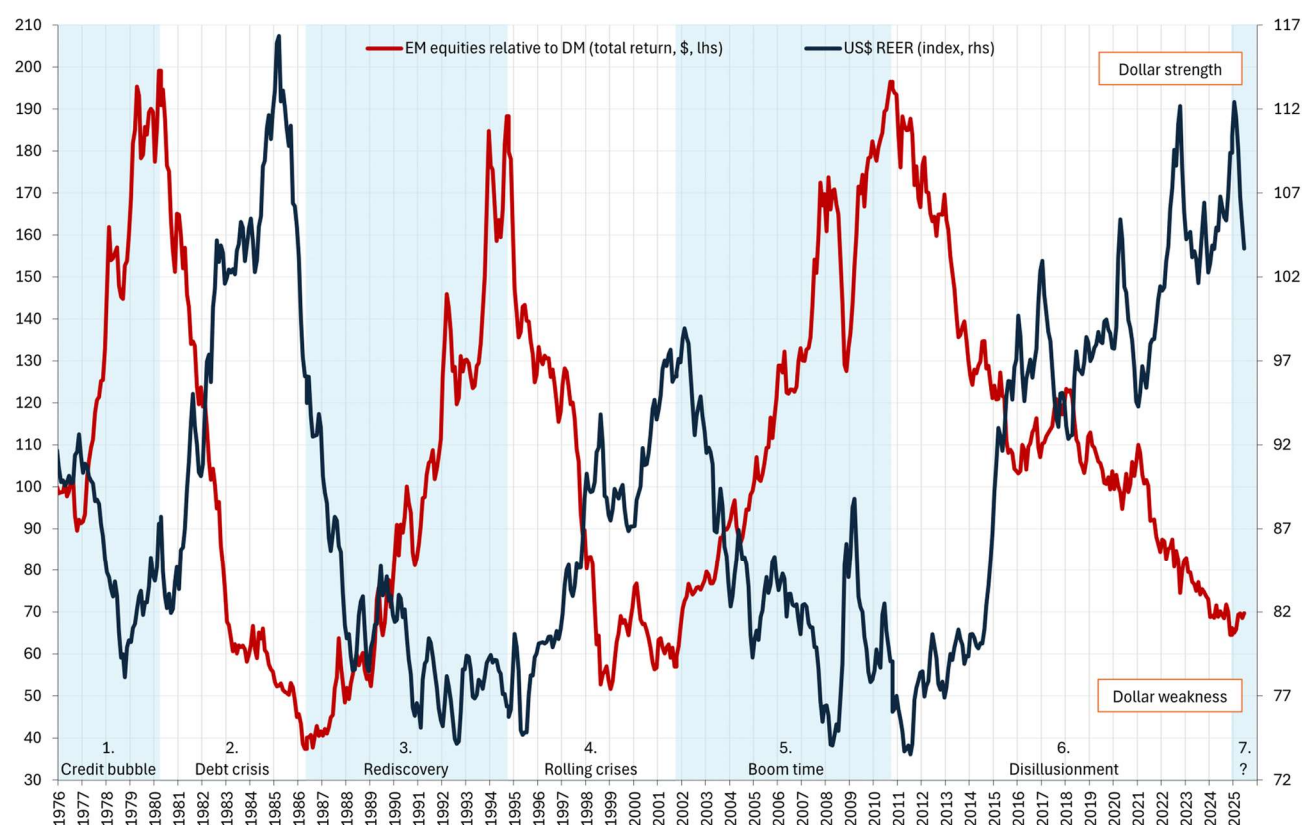
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We explore the long-term relationship between the US dollar and Emerging Market equities over half a century and six distinct phases of dollar strength and weakness. After 15 years of EM equity underperformance, could a weaker dollar herald a renaissance for EM assets? Or will geopolitics, fragmented global trade and disrupted financial flows undermine the story?

The US Dollar and EM relative performance since end-1975

EM equities relative to DM (total return, \$, lhs) vs US\$ REER (index, rhs)



Note: IFC Composite Index for 31 Dec 1975–31 Dec 1987, MSCI Emerging Markets Index from 31 Dec 1987, relative to MSCI World. Real effective exchange rate – narrow basket (27 countries)

Source: BIS, IFC, MSCI, Weighhouse

Bankers who were paying attention as graduate trainees might recall the bond market dance: one arm up, the other down, illustrating “yields up, prices down,” and vice versa.

For EM investors, a similar shorthand has long applied: “dollar up, EM equities underperform.” Unfortunately, the reverse – “dollar down, EM equities outperform” – hasn’t really applied for the last decade and a half.

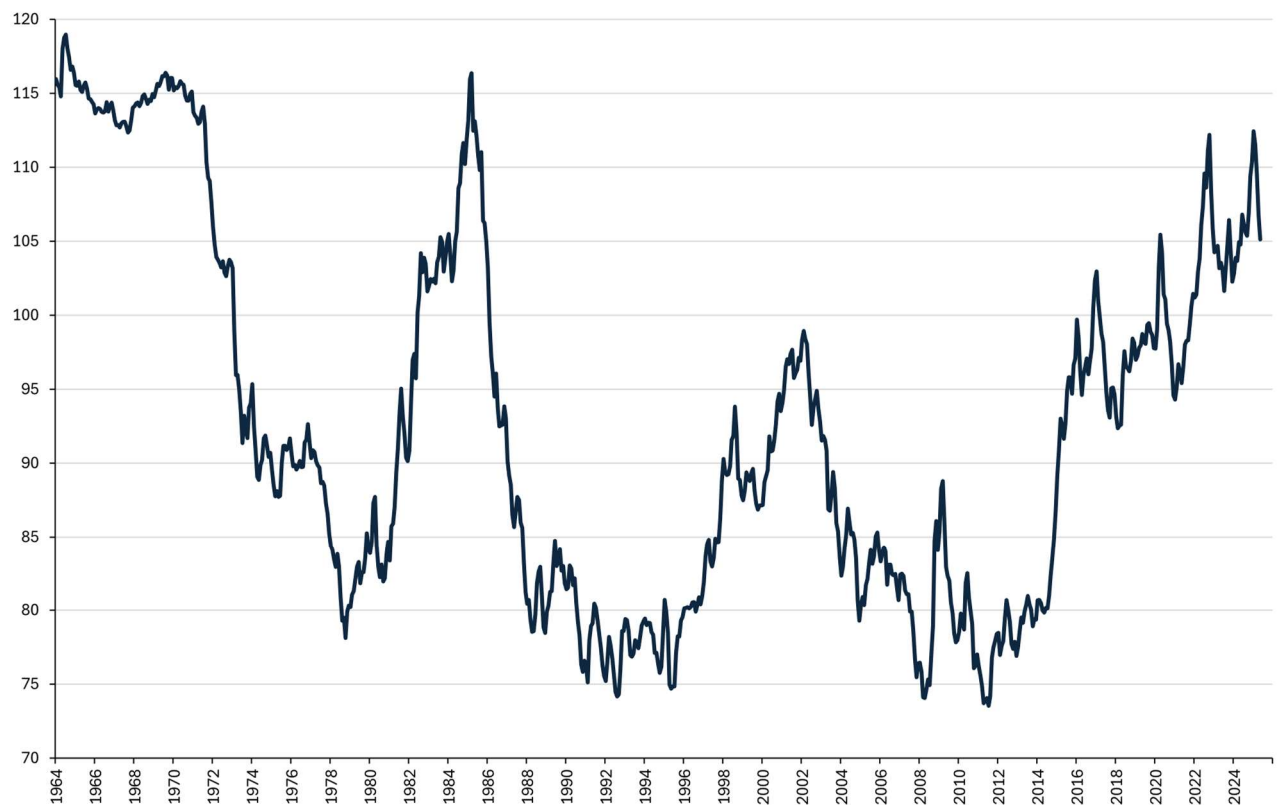
Until this year.

In the first half of 2025, the dollar fell 11% against a basket of major trading partners, its worst start to a year in over half a century. While the dollar entered 2025 from an exceptionally strong position and US policymakers had signalled a preference for a weaker currency, the speed and scale of the drop have surprised many observers. EM equities responded in kind: the benchmark MSCI EM index rose 16%, outperforming Developed Markets, where MSCI World rose 10% (total gross returns in dollars).

Many factors will shape the dollar's path from here. But in January, the dollar's real effective exchange rate came within 4% of two important historic peaks: 1969 (ahead of the collapse of Bretton Woods) and 1985 (prior to the Plaza Accord), and comfortably exceeded the 2001 high, making a turn seem increasingly plausible, given the right catalysts.

Sixty-year trading range for the dollar

US\$ real effective exchange rate (index)



Note: Narrow basket, 2020=100

Source: BIS, Weighhouse

Why is dollar weakness good for EM?

- **Dollar-denominated debt:** Governments and corporates with dollar borrowings benefit from cheaper debt servicing as repayments fall in local currency terms.
- **Import costs and inflation:** A weaker dollar lowers import prices, easing inflationary pressures and giving EM central banks more scope to maintain lower interest rates.
- **Improved returns for dollar-based investors:** Stronger EM currencies translate to higher dollar returns for international investors.
- **Capital flows:** Dollar weakness often signals a “risk-on” environment, encouraging capital to flow out of the dollar and into EMs. These inflows can help fund budgets and current accounts, while supporting asset prices, investment and growth.

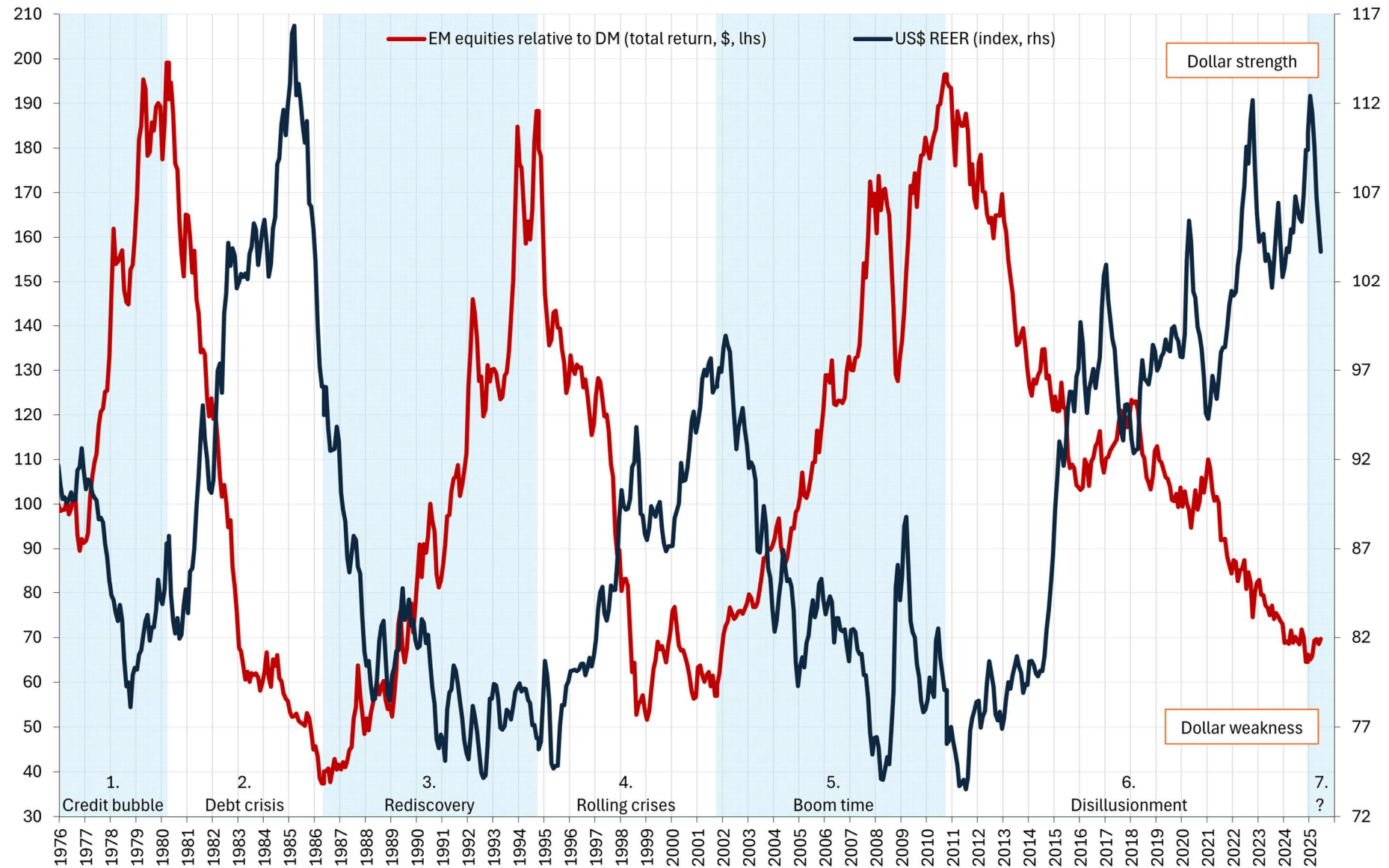
By contrast, a strong dollar raises debt servicing costs, draws capital away from EMs, and puts pressure on EM currencies, driving up import costs, fuelling inflation, and potentially forcing interest rate hikes to stabilise exchange rates. Sudden currency weakness in EMs can feed risks to the financial sector as well as economic and social stability.

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GLOBAL THEMATICS

The US Dollar and EM relative performance since end-1975

EM equities relative to DM (total return, \$, lhs) vs US\$ real effective exchange rate (index, rhs)



Note: IFC Composite Index used for 31 Dec 1975–31 Dec 1987, MSCI Emerging Markets Index from 31 Dec 1987, relative to MSCI World. Real effective exchange rate – narrow basket (27 countries)

Source: BIS, IFC, MSCI, Weighhouse

A historical lens: Six dollar-driven EM cycles

The chart above shows 50 years of EM total returns relative to DM (in red) alongside the dollar's real effective exchange rate (in blue). To capture the full picture, the series includes more than a decade of data from before the MSCI EM index's inception at the end of 1987. Over this period, EM has cycled through six clear phases of outperformance (blue shading) and underperformance (white), each closely tied to shifts in the dollar.

1. 1970–1980 Credit bubble (weak dollar)

In the 1970s, US banks lent heavily to what were then known as Less Developed Countries (LDCs). Lending in the 1950s and 60s had aimed to support industrialisation but increasingly went towards financing deficits as global economic conditions worsened. The collapse of Bretton Woods in 1971, followed by oil shocks and rising inflation, triggered a sustained bear market for the dollar.

2. 1980–1986 Debt crisis (strong dollar)

In response to double-digit inflation, Paul Volcker's Federal Reserve raised interest rates sharply during 1979–1980, peaking at 20%. The dollar surged. US banks pulled back lending, and many EMs, having borrowed heavily in floating-rate dollars, struggled to repay. Over 40 countries fell into arrears; 27 restructured their debts. The crisis dragged on into the late 1980s, until debt relief, the Brady Plan and falling global interest rates restored debt sustainability in EM.

3. 1986–1994 Rediscovery (weak dollar)

The 1985 Plaza Accord weakened the dollar, and as the debt crisis receded, investor interest in EM revived. The emergence of new markets after the Cold War, the end of hyperinflation in Latin America and Eastern Europe, and the dismantling of capital controls paved the way for global EM equities to become a viable asset class, marked by the launch of the first global EM fund in 1986. Following the 1990–91 recession, Alan Greenspan's Fed maintained low real interest rates, fuelling what the IMF called "five fat years" of growth and investment inflows into EMs between 1990 and 1994.

4. 1994–2002 Rolling crises (strong dollar)

The period began with China's renminbi devaluation in 1994, alongside the start of hiking cycle which would see the Fed funds rate double from 3% to 6% over twelve months. Mexico's Tequila crisis followed later that year, marking the start of an eight-year period of EM instability. The Asian Financial Crisis erupted in 1997, spreading rapidly from Thailand to Malaysia, the Philippines, Indonesia, and South Korea, as currency pegs were abandoned. Russia defaulted in 1998, triggering the collapse of Long-Term Capital Management and prompting Fed rate cuts. Those

cuts helped fuel the tech bubble, but EM crises rumbled on: Brazil devalued in 1999; Turkey and Argentina faced crises in 2001; and Uruguay and Brazil (again) followed in 2002.

5. 2002–2011 **Boom time** (weak dollar)

China's accession to the WTO at the end of 2001 unleashed a wave of industrialisation, urbanisation, and commodity demand, while putting downward pressure on manufactured goods prices. With subdued inflation allowing only very gradual Fed tightening, this supported a global growth boom. For EM, benefitting from competitive currencies following earlier crises, the period was marked by narrowing bond spreads and strong inflows. Although the Global Financial Crisis initially impacted EMs more than DMs, their recovery was much steeper, helped by China's massive stimulus programme.

6. 2011–2025 **Disillusionment** (strong dollar)

A relatively strong US economy, contrasting with crisis and then stagnation in the eurozone, kept US interest rates persistently higher than those of its peers. Rising global savings and perceptions of US exceptionalism, including the success of its tech sector and emergence as a net energy exporter, helped support the dollar.

In contrast, China's post-GFC growth slowed. Stimulus was initially constrained by rising inflation, and later, particularly after COVID, growth was further weighed down by demographics and a hard landing in the property sector. Rising debt levels also reduced the state's appetite for large-scale stimulus. Meanwhile, state intervention in tech stood in stark contrast to the US tech boom.

Slower Chinese growth and falling commodity prices exposed uncompetitive currencies and a lack of reform across several emerging markets. At the same time, rising geopolitical tensions, from US-China friction to Russia's war in Ukraine, added further headwinds.

2025 and beyond: a Renaissance?

Are we at the dawn of a new cycle, a seventh phase, **Renaissance**, where a weaker dollar supports EM outperformance ? Or will geopolitics, fragmented global trade and disrupted financial flows undermine the story?

There are several arguments in favour of further dollar weakness:

- Signs that the US economy is slowing.
- Fed rate cuts of 50 basis points by year-end appearing increasingly likely.
- Worsening US budget and debt metrics.
- Longer-term, though harder to quantify, structural risks to the dollar's "exorbitant privilege", including concerns over policy predictability, institutional governance and domestic political polarisation, as well as the potential impact of fragmented global trade and capital flows on dollar demand and deficit financing.

Still, the perennial question remains: *if not the dollar, then what?* And the dollar's sharp decline so far this year could warrant a pause for breath. But with the US now representing around a quarter of global GDP, down from 35% in 1985, greater global portfolio diversification seems inevitable, which should support the EM story.

And within EM, those concerned about geopolitical risks can opt for a more targeted strategy, splitting exposure between EM ex China and dedicated China baskets allocations.

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