# The impact of a stronger US dollar and higher US treasury yields on emerging markets

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**Can emerging market bonds still offer opportunities when the US dollar is rising?**

Emerging markets have endured a difficult couple of months, with losses stemming from both weaker currencies and higher underlying yields. Hard currency spreads have also widened. For example, the JP Morgan local currency index is down nearly 9% from its mid-April peak, whilst the JP Morgan hard currency index spread is about 100bps wider than its 2018 tights.

Whilst, some of the weakness has been the result of very specific problems in economies such as Turkey and Brazil, the broad-based pressure has come from a combination of higher US treasury yields and a stronger US dollar. In previous episodes, emerging markets have been able to withstand either a stronger US dollar or higher US treasury yields, but the combination of both is undoubtedly a tough backdrop for the asset class.

Between mid-April and its peak at the end of May the trade weighted US dollar strengthened by 6% to a 1 year high whilst 10 year US treasury yields are 55bps higher this year.

In emerging market currencies amongst the worst affected has been the Brazilian real (-11%) and the Turkish lira (-17%). Both of these countries have specific pressing problems but other large index constituents such as Mexico and South Africa have seen their currencies fall by 14% and 9% respectively against the US dollar since mid-April.

Local rates have also risen. The local currency index overall yields over 7.6% but within that there have been some significant increases. For example, Brazil 2028s now yield 9.7%, Turkey 2023s yield 16.5% and South Africa 2048s yield nearly 10%.

Overall we expect the US dollar and US yields to rise further but this does not mean that the adjustments will be linear or that we have to avoid emerging markets altogether. Our strategy is to focus on specific local rates markets where we judge there to be excess value and a positive underlying dynamic.

Our two most significant local currency investments are in Mexico and South Africa. We think Mexican bond yields look attractive given the ambitious fiscal tightening planned and the expected fall in inflation. We also think that the risks of a bad outcome for Mexico in the NAFTA negotiations are overstated.

Our position in South Africa is based on the ability of the new, reform-minded President to take the political and economic steps required to set the country on a sounder footing.

And with yields on these positions of between 8% and 10% and on the back of recent currency weakness, we think we are being well paid for the inevitable volatility that will accompany this type of investment. Yields like these are simply not available in developed credit markets.

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