If the Dollar Depreciates, Might It Be Time for Emerging Markets to Shine?

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Key Takeaways

- The U.S. dollar's strength, driven by the Fed's higher interest rate policy to control inflation, may weaken as rates are lowered, potentially benefiting emerging market equities.
- U.S. equities, especially large companies, have outperformed since the global financial crisis, but emerging market equities have historically outperformed during periods of dollar depreciation.
- WisdomTree offers diverse emerging market equity funds, each with unique focuses, like high dividends, quality growth and small-cap stocks, and influenced by regional stability and market characteristics.

The U.S. dollar has been strong, partially driven by the high interest rate policy of the U.S. Federal Reserve (Fed) in recent years to get inflation under control.

With the Fed poised to start lowering rates, some are speculating that the U.S. dollar may go through a period of depreciation. Who stands to benefit from such a regime change?

Emerging market equities.

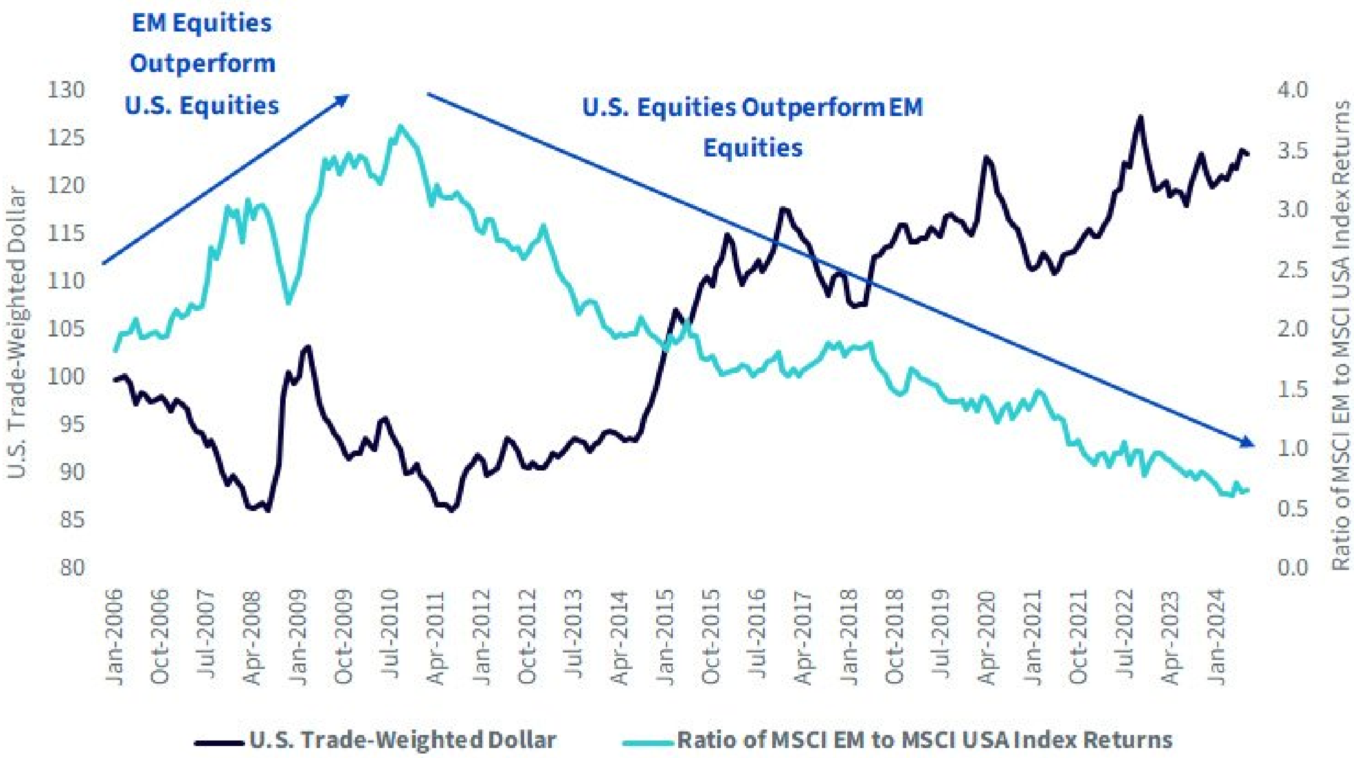
Dollar Strength and U.S. Equity Dominance

Coming out of the global financial crisis of 2008–2009, few equity markets kept up with the U.S. markets.

- Capital has flowed strongly into the U.S., chasing these returns and bidding the U.S. dollar higher, in general, over this period.

In figure 1, we note the ratio of cumulative performance, looking at the MSCI USA Index (U.S. equities) and the MSCI Emerging Markets Index (EM equities) as we also plot a measure of the U.S. dollar against a basket of other currencies.

Figure 1: Emerging Market Equities Underperformed U.S. Equities as the U.S. Dollar Appreciated

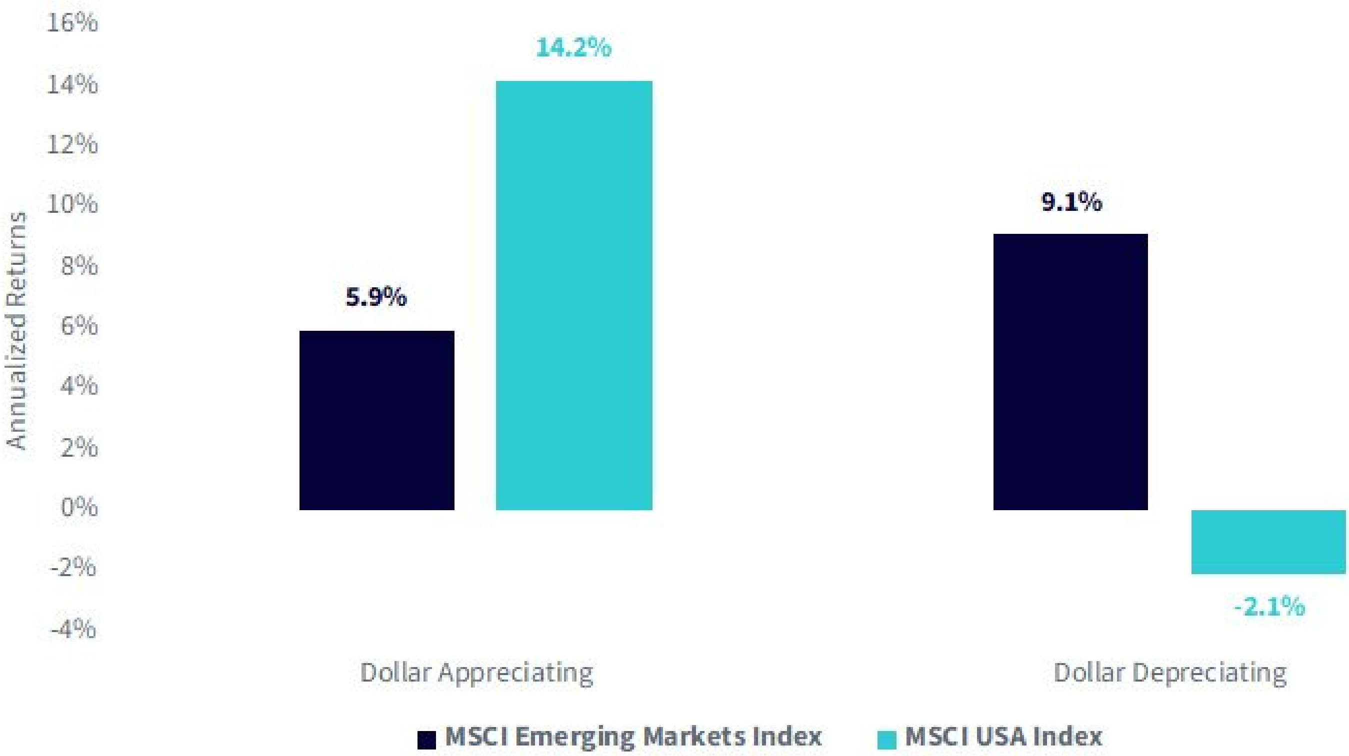


Sources: MSCI, Board of Governors of the Federal Reserve System (U.S.), Nominal Broad U.S. Dollar Index [DTWEXBGS], retrieved from FRED,
Federal Reserve Bank of St. Louis for the period 1/1/06–7/1/24. You cannot directly invest in an index. **Past performance is not indicative of future results.**

If we dig into the two distinct periods, denoted from basically the end of August 2010 to the present for "Dollar Appreciating" and from the start of the time series to August 2010 for "Dollar Depreciating," we see figure 2:

- The MSCI USA Index, on an annualized basis, significantly outperformed as the U.S. dollar appreciated. Also, we would note that the MSCI Emerging Markets Index return is measured in local terms, so it is not running into a currency headwind in these figures.
- On the other hand, while the dollar depreciated, the MSCI Emerging Markets Index, albeit for a shorter overall period, dramatically outperformed the MSCI USA Index. Some of us might have forgotten what it looks like to see emerging markets outperforming U.S. equities in a sustained way.

Figure 2: Emerging Market vs. U.S. Equities in Periods of Dollar Appreciation and Depreciation



Source: MSCI. "Dollar Appreciating" refers to the period 8/31/10–7/31/24. "Dollar Depreciating" refers to the period 12/31/05–
8/31/10. **Past performance is not indicative of future results.**

There Are Many Flavors of Emerging Market Equities

WisdomTree has a range of options for emerging market equities, a number of which have been around for longer than 10 years.

- The WisdomTree Emerging Markets Quality Dividend Growth Fund (DGRE) seeks to track the investment results of dividend-paying companies with growth characteristics in the emerging markets region.
- The WisdomTree Emerging Markets High Dividend Fund (DEM) seeks to track the total return performance, before fees, of the WisdomTree Emerging Markets High Dividend Index. The focus is on higher-yielding dividend payers within emerging markets.
- The WisdomTree Emerging Markets SmallCap Dividend Fund (DGS) seeks to track the total return performance, before fees, of the WisdomTree Emerging Markets SmallCap Dividend Index. The focus is on dividend-paying smaller market capitalization stocks within emerging markets.

The most widely followed emerging market equity performance benchmark is the MSCI Emerging Markets Index.

Recent Evolutions of Emerging Market Equity Performance

If we look at DGRE, DEM and DGS relative to the MSCI Emerging Markets Index on a performance basis, we see different things over different periods:

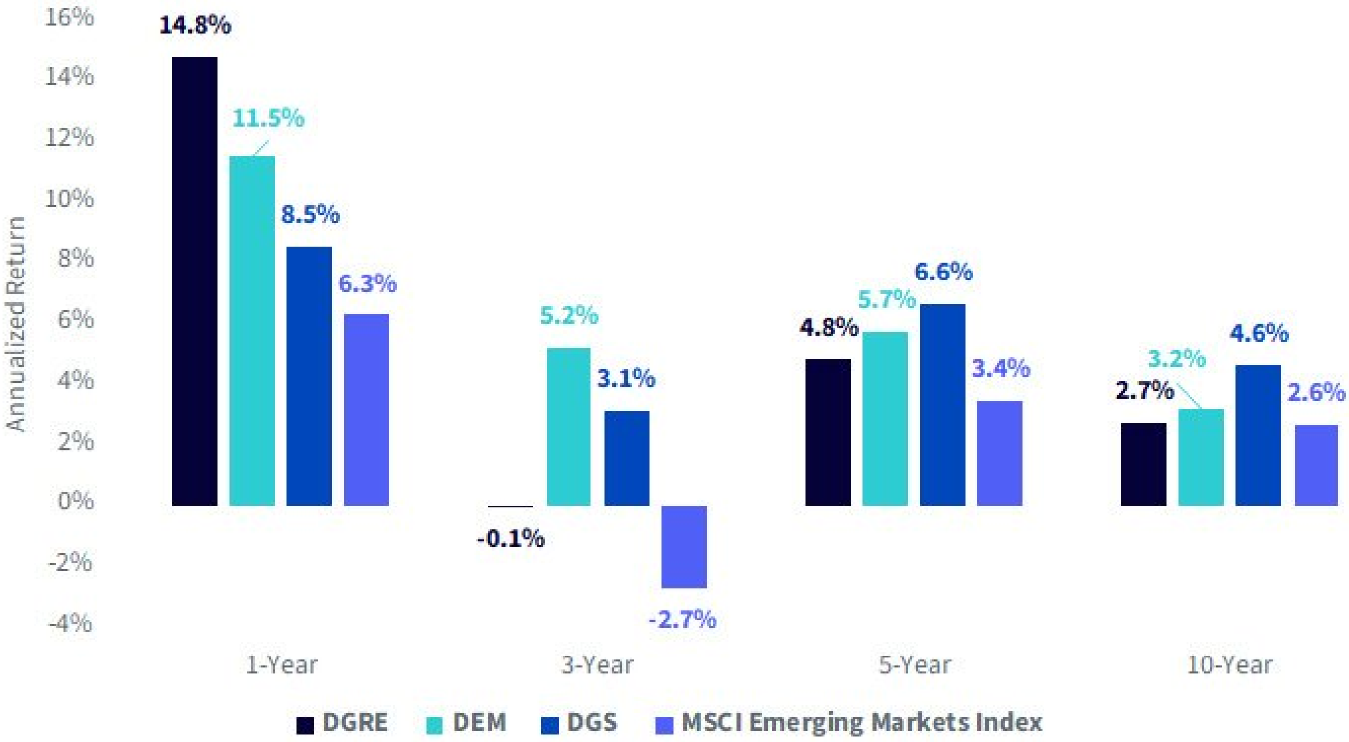
- Those looking at the long term, periods like 5 years or 10 years, see that DGS has been the leader.
- Those looking at the most recent three years see the defensive nature of DEM has come to the fore.
- Those looking over the past year see DGRE taking the lead.

Figure 3a: Average Annual Total Returns

Fund/Index Name	Fund Ticker	Fund Expense Ratio	Fund Inception Date	Year-to-Date	1-Year	3-Year	5-Year	10-Year	Since Fund Inception
WisdomTree Emerging Markets Quality Dividend Growth Fund (NAV)	DGRE	0.32%	8/1/13	8.73%	19.46%	-1.36%	4.32%	2.70%	3.06%
WisdomTree Emerging Markets Quality Dividend Growth Fund (MP)	DGRE	0.32%	8/1/13	8.47%	18.34%	-1.22%	4.21%	2.67%	2.88%
WisdomTree Emerging Markets High Dividend Fund (NAV)	DEM	0.63%	7/13/07	8.54%	20.66%	5.14%	5.68%	3.38%	3.80%
WisdomTree Emerging Markets High Dividend Fund (MP)	DEM	0.63%	7/13/07	8.56%	19.95%	5.20%	5.66%	3.45%	3.63%
WisdomTree Emerging Markets SmallCap Dividend Fund (NAV)	DGS	0.58%	10/30/07	5.22%	16.31%	2.93%	6.66%	4.74%	3.81%
WisdomTree Emerging Markets SmallCap Dividend Fund (MP)	DGS	0.58%	10/30/07	4.52%	15.11%	2.79%	6.45%	4.69%	3.78%
MSCI Emerging Markets Index				7.49%	12.55%	-5.07%	3.10%	2.79%	

Sources: WisdomTree, MSCI. Fund data specifically from the Fund Comparison Tool in the PATH suite of tools, as of 6/30/24. **Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. For the most recent month-end performance, click the relevant ticker: DGRE, DEM and DGS.** WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

Figure 3b: Different Periods Have Exhibited Different Performance Leadership in Emerging Market Equities



Sources: WisdomTree, MSCI. Fund data specifically from the Fund Comparison Tool in the PATH suite of tools, for the period
7/31/14–7/31/24. **Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. For the most recent month-end performance, click the relevant ticker: DGRE, DEM and DGS.** WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

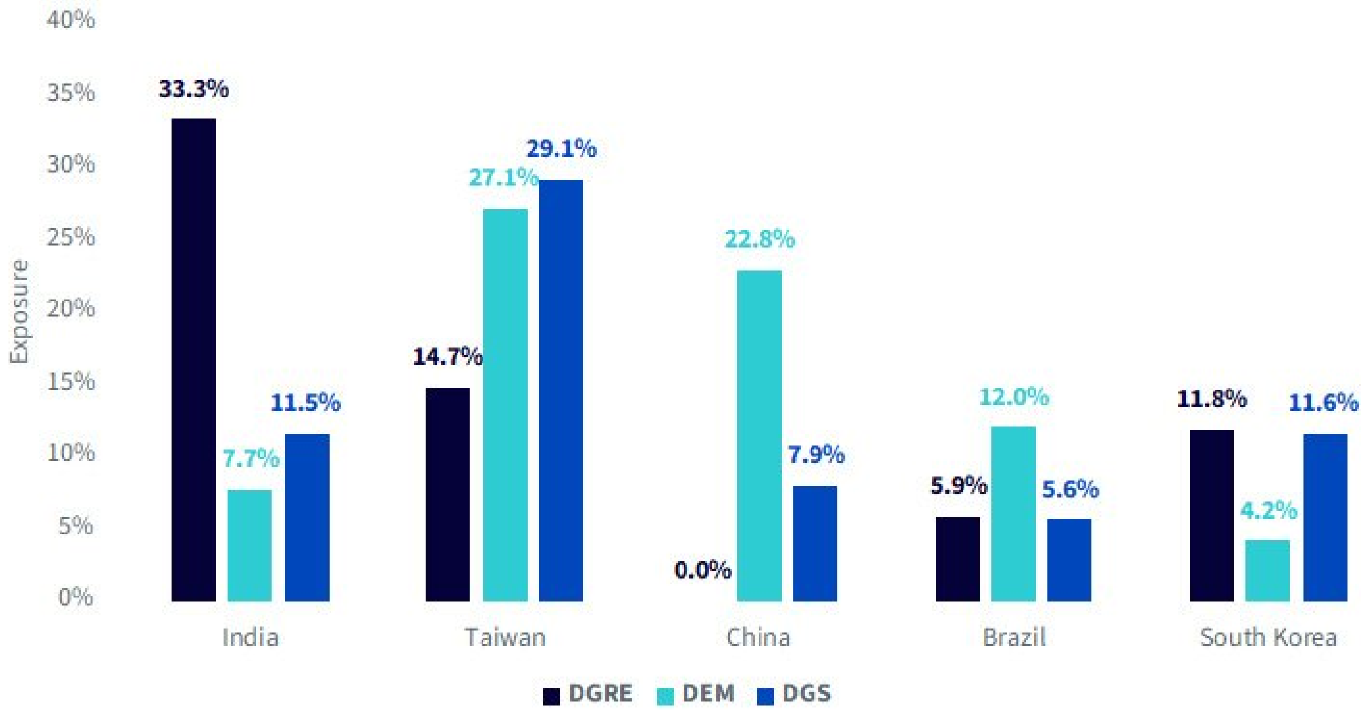
Location, Location, Location…

When people talk about real estate, all of us know the mantra—location, location, location. In emerging market equity investments, the same mantra applies.

The world has been very excited about the stability of India, in that the country has elected the same leader through three elections. Even if no government is perfect, sometimes stability and the capability to actually implement policy over a longer time is more important than any one leader being perfect. Business and investment can follow as long as people know what is going on. As we look to figure 4:

- DGRE has roughly one-third of its assets in India’s equities.
- Taiwanese companies have a culture of paying dividends, and this market has been well-represented in DEM and DGS for many years.
- China is a polarizing topic across the U.S., particularly in an election year. In fact, people might even say it is not polarizing because it feels like it could be one’s patriotic duty to be “against China.” On a pure benchmark basis, China has the biggest equity market by market capitalization in emerging markets. Many strategies have significant exposure. DGRE has taken the opposite stance, offering investors a way to have a diversified approach but without any China exposure. While we don’t know if China will always underperform, we think the geopolitical conflicts and economic challenges motivate more options like DGRE for investing in emerging markets ex-China.
- Brazilian equities have historically been characterized by higher dividend yields, leading to more exposure in DEM.
- South Korea, on the other hand, does not tend to be a high-yielding dividend market, but it is at least looking at some Index providers like FTSE. It is a developed country,2 so there is a lot of equity market activity with some very interesting global companies to choose from.

Figure 4: Location, Location, Location—the Country Exposures of DEM, DGRE and DGS



Source: WisdomTree, specifically the PATH fund comparison tool, with data as of 6/30/24. Holdings subject to change.

Earnings Growth or High Dividend Yields?

One of the trade-offs that investors often have to make is as follows:

- One group of stocks has a low valuation, possibly seen through a very high dividend yield or a very low P/E ratio. There are some who see this and find it exciting, not needing to know too much more. There are others who tell us, yes, but…aren't these companies "cheap for a reason"? This is a version of asking—what if this is a "value trap"? It is absolutely true that certain companies may be inexpensive on a valuation basis and getting even more inexpensive, potentially even going out of business.
- Another group of stocks may not have as low a valuation but may have stronger earnings growth metrics. Usually, companies with better earnings growth metrics never showcase the lowest valuation metrics because investors appreciate the growth in earnings and tend to bid the share price levels higher.

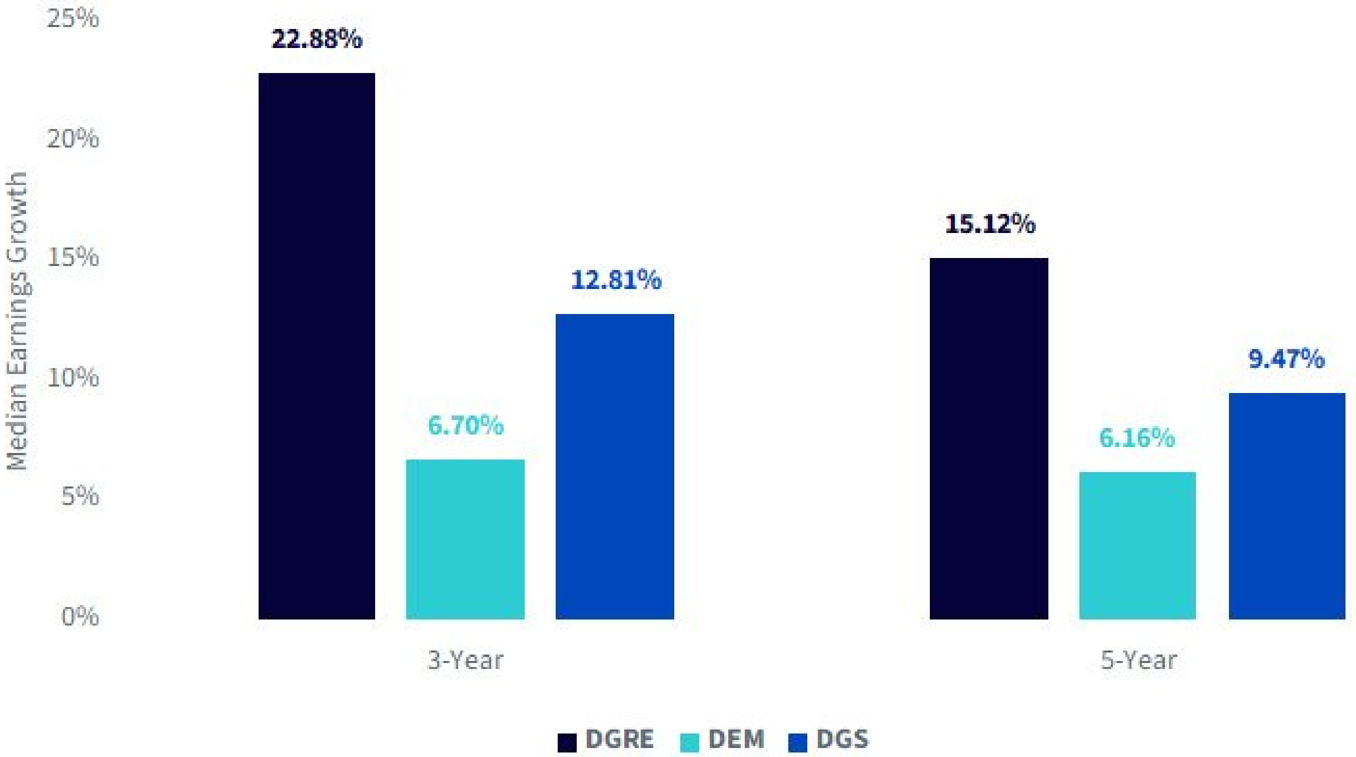
Historically, DEM's strategy of following the highest-yielding dividend payers has been more defensive in consistently finding the lowest valuations but also finding the lowest earnings growth.

DGRE is meant to be a contrasting style of investment, finding companies with stronger earnings growth over time.

DGS is a bit different, being more of a broad-market small-cap strategy exposed to hundreds of underlying stocks. Emerging market companies pay dividends very early in their respective life cycles.

We see a version of this story playing out in figure 5.

Figure 5: Where Is the Earnings Growth in EM?



Source: WisdomTree, specifically the PATH fund comparison tool, with data as of 6/30/24. **Past performance is not indicative of future results.**

Conclusion: Know Your Regional Exposures

What are emerging markets? What are developed markets? The real answer these days is that it depends on who you ask. It is more important than ever to look under the hood and think about which countries might be poised to provide strong, pro-business conditions.

1 Apple, Amazon, Meta Platforms, Alphabet, Tesla, Microsoft and Nvidia.

2 Source: Christopher Woods, “Classifying South Korea as a Developed Market,” FTSE Russell, 1/13. https://research.ftserussell.com/products/downloads/FTSE_South_Korea_Whitepaper_Jan2013.pdf

Important Risks Related to this Article

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