

**INVESTMENT NOTE**

**23 FEBRUARY 2015**

**HERMES: EMERGING MARKETS RESILIENT AS OIL FALLS AND THE DOLLAR RALLIES**

*In past cycles, emerging market equities have fallen in sync with oil prices and suffered amid US dollar strength. This time, the winners from cheap oil outnumber the losers, explains Oliver Leyland CFA, Senior Investment Analyst – Latin America, Hermes Emerging Markets.*

**Going separate ways:** Since mid-2014, historically high correlations between the MSCI Emerging Markets Index and both oil prices and the US currency have broken down (see the charts below). Determining whether this divergence is temporary or sustainable could strongly influence decisions by emerging market investors in the near term. The question we have asked, therefore, is: will emerging market equities sell off amid weak oil prices and a strong dollar, as in previous cycles?

**Emerging market equities v the US dollar, 2005-present**



Source: Bloomberg as at 5 February 2015. The correlation between emerging market equities and the US dollar is measured by the inverse of the Trade Weighted Dollar Index

**Emerging market equities v the price of crude oil, 2005-present**



Source: Bloomberg as at 5 February 2015.

**It's different this time:** the current oil-price slide is unlike many of those in the past. What markets have experienced over the past year, and which has accelerated since the OPEC meeting in late November 2014, is a supply side shock as chief oil-price setter Saudi Arabia prioritises market share over price. This differs materially from 2008, when collapsing global growth sunk demand. Meanwhile, the drivers of the dollar's strength are more nuanced, though to some extent caused by the economic weakness of the eurozone and Japan, rather than emerging markets.

**No longer a commodity play:** emerging markets are also less leveraged to oil prices this time. In 2007, the energy sector accounted for 18% of the MSCI Emerging Markets Index, and this has fallen to 8% today. The exposure of the index to what we define as energy markets – those countries whose equity markets have an exposure of greater than 15% to the energy sector – has fallen from more than 12% in 2008 to less than 7% now. To illustrate the point, in February 2008 Gazprom and Petrobras were the largest two stocks in the index but are now the 19th and 20th largest respectively. As the weighting to energy in the index has contracted, the IT sector has almost doubled from 10% to 19%.

**Winners and losers:** since 2008, the exposure of the index to oil exporters has diminished. As beneficiaries of cheaper oil, importing countries like China, India, South Korea and Taiwan can be seen as current-account “winners” and now represent 70% of the index, up from 59%. Oil exporters, the current-account “losers”, now represent only 13% of the index, down from 17% in 2008. In economic terms, the combined balance sheet of emerging markets is an overall winner from the fall in oil prices.

**Reasons for resilience:** given these developments, we believe that the likelihood of emerging markets being broadly hit by a balance of payments shock is lower than when oil has fallen and the dollar surged in past cycles. We do not deny the potential for pockets of stress in mis-managed emerging economies that have become too reliant on energy exports, such as Russia, Venezuela and Nigeria. But all else being equal, emerging market equities have the potential to perform resiliently.

The **Hermes Global Emerging Markets Fund** outperformed the MSCI Emerging Markets Index by 4.45% and 4.25% in the one- and three-year periods to the end of December 2014 respectively. Its 2.53% exposure to energy stocks contrasts with the benchmark's 8.03%, resulting in a -5.50% active weight.<sup>1</sup>

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**Notes to Editors:**

**Hermes Investment Management**

Hermes is focused on delivering superior, sustainable, risk adjusted returns for our clients – responsibly.

Hermes manages assets on behalf of more than 200 clients\* across equities, fixed income, alternatives and real estate, with £28.6 billion\* assets under management. In Hermes EOS, we have the industry's leading engagement resource, advising on more than £134.0 billion\* of assets.

We believe in **Excellence, Responsibility** and **Innovation**

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<sup>1</sup> **Hermes Global Emerging Markets Fund** Performance shown is the F share class sterling Accum net of all costs and management fees since seeding on 08 November 2012, prior track record is the Z share class sterling Accum, fee and currency adjusted since inception net of all costs. Subscription and redemption fees are not included in the performance figures. Funds with a mid-month inception date show part period performance for that month. Performance as at 31 December 2014.

- **Excellence:** We aspire to excellence in everything we do. This manifests itself most visibly in our investment performance. We will only offer products to our clients where we believe there is a strong investment thesis and where we can deliver sustainable alpha.
- **Responsibility:** We believe it is our responsibility to lead discussion and debate about the fiduciary responsibilities of fund managers to our clients, their stakeholders and, ultimately, society at large. We have always sought positive engagement with the firms in which we invest.
- **Innovation:** We have the entrepreneurial culture to identify forward-looking products that meet those needs, along with the resources and speed-to-market mentality to develop them rapidly.

Our structure gives clients globally the benefit of access to a broad range of specialist, high conviction investment teams operating within an established and robust operating platform.

Hermes' investment solutions include:

- **Equities:** Global, Emerging Markets, Small & Mid Cap, Europe, Asia Ex Japan, Greater China
- **Fixed Income:** Inflation-Linked, Government Bonds, Investment Grade, High Yield
- **Real Estate:** Segregated, Unitised, Debt, UK, US Residential, European, UK PRS
- **Alternatives:** Multi Asset, Infrastructure, Private Equity

\*Please note the total AuM figure includes £3.7bn of assets managed or under an advisory agreement by Hermes GPE LLP ("HGPE"), a joint venture between Hermes Fund Managers ("HFM") and GPE Partner Limited. HGPE is an independent entity and not part of the Hermes group. £0.4bn of total group AuM figure represents HFM mandates under advice. Source: Hermes as at 31 December 2014.