

Kyklos Capital

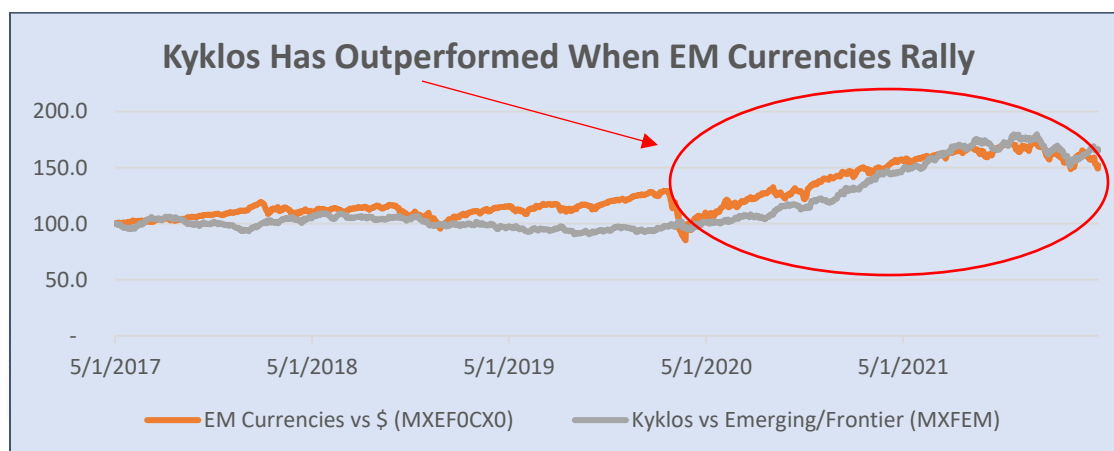
Outlook: Dealing With Dollar Risk.

“The dollar is our currency, but it’s your problem.” Former U.S. Treasury Secretary John Connally

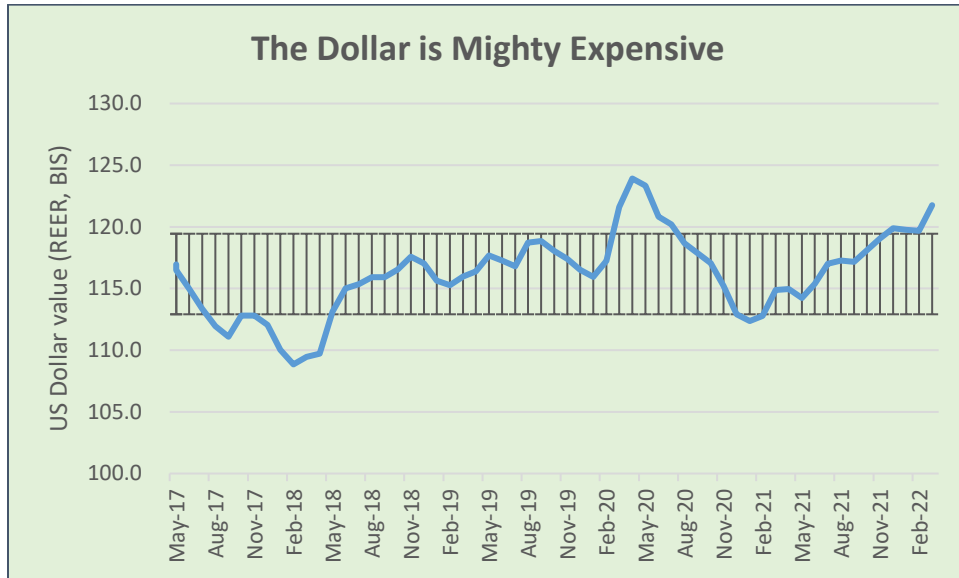
No. 1 on the wish-list of emerging market investors is to see a weaker U.S. dollar. Long-term, emerging equity market returns have been positive in 65% of years when the dollar declined, with an average +22% return, almost double that of the S&P 500. On the other hand, emerging markets rally only 50% of years with a strong dollar, returning a meager +2.7% on average.¹ Kyklos’ bottom-up investment process deals with these risks in several ways.

Risk #1: The amount and cost of U.S. dollar debts, in local currency terms, balloon when the dollar rises. This is true for both countries that issue sovereign bonds, and for companies that borrow from banks or issue other debt. Kyklos’ stock-picking process generally avoids this risk at the company level, because we specifically choose companies with low debt levels and with high and sustainable profitability. We also like businesses that are naturally hedged against weakness in their local currencies, such as exporters with significant revenues in dollars and costs in local currencies, and about one-half of our portfolio has this profile. Operating margins of such firms increase when the dollar rises, unlike emerging market firms overall. We tend to see positive earnings surprises for these companies when the dollar is strong, and these stocks often outperform their local markets as a result.

Risk #2: Foreign investors tend to enter or exit emerging-market positions based on the dollar. This puts direct pressure on share prices. As emerging currencies mainly rose in 2020-21, Kyklos outperformed small emerging & frontier markets (below). This likely reflects increasing foreign buying, and has duly reversed so far in 2022. We therefore root for a weak dollar.



¹ See <https://fortune.com/2020/08/08/us-dollar-usd-weak-investing-advice-coronavirus-covid-investors/>.



The good news is that **a weak dollar may be ahead of us**. The dollar's upward rip from "cheap" levels just one year ago leaves it looking "expensive" once again, well above one standard deviation above its long-term average value (above). As a timing tool it remains unpredictable, but we look forward to having the dollar as a tail-wind instead of head-wind to our performance, in coming periods.

Charlie Gushee
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