# Stock market returns track the strength of the dollar

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A new paper in *Oxford Open Economics*, published by Oxford University Press, shows that the US dollar can be considered as a major global factor that investors look at when making their portfolio allocation decisions in stock markets in emerging economies. The global integration of banking and capital markets means that the growing heft of global investors, such as banks, mutual funds and hedge funds, has influenced domestic financial conditions in emerging market economies and that exchange rates have become increasingly important to capital flows to these economies.

Researchers here measured performance using the Morgan Stanley Capital International country indices for 50 emerging market economies from January 2006 to August 2021. They find that higher stock returns in local currency terms tend to accompany an increase in the value of the local currency against the dollar, and vice versa. Therefore, dollar exchange rate changes tend to accentuate stock market returns.

Then, investigators here introduce the "dollar beta," defined as the sensitivity of stock returns to swings in the broad dollar index, the value of the US dollar relative to other currencies. Researchers find that that an appreciation of the broad dollar index is associated with a decline in local currency stock returns.

Finally, they find that emerging market economy stocks that have a high dollar beta, meaning very sensitive to currency value shifts, tend to have higher average returns, suggesting that investors who hold stocks in a high dollar beta stock market are compensated for the higher risk by a higher average return.

While central banks do not normally intervene in domestic equity markets through the direct purchase of stocks, the researchers here believe that the relationship between the appreciation of the US dollar and domestic financial conditions suggests that central banks and financial authorities may benefit from monitoring the size of foreign investments in local stock markets and the characteristics of investors, as well as from conducting stress tests.

"The financial channel of exchange rates operates through the risk capacity of market participants and shows up in the response of financial conditions to exchange rate movements," said Hyun Song Shin, one of the paper's authors. "Dollar-denominated returns tend to be an amplified version of the local currency-denominated returns; both the gains and losses are magnified when converted into dollars."

**More information:** Dollar beta and stock returns, *Oxford Open Economics*, academic.oup.com/ooec/article- … 10.1093/ooec/odac003

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