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Surging 'Trump dollar' risks earthquake for emerging markets

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Turkey is the weakest link in latest emerging market storm, but China is what matters most

The resurgent 'Trump' dollar is setting off an incipient credit crunch across large parts of the world economy, forcing countries to tighten monetary policy or intervene in the exchange markets to defend their currencies.

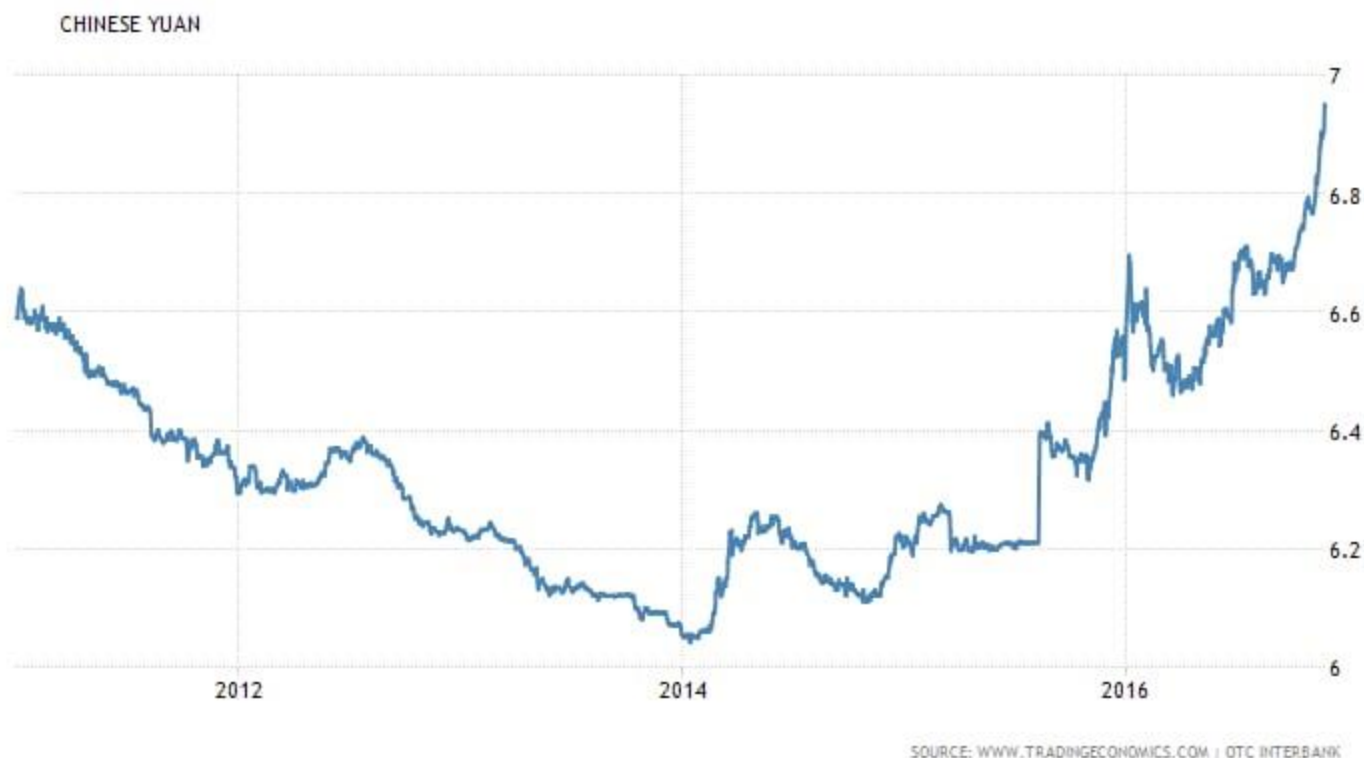
The dollar index (DXY) reached a fresh 14-year high of 102 overnight as global markets rotate violently into the US "reflation trade', betting that Donald Trump's eye-watering fiscal expansion will prove a replay of Reaganomics in the early 1980s.

Rocketing US bond yields have triggered a global stampede into US assets, draining the international system of dollar liquidity. It is the exact opposite of what happened in the glory days of the emerging market boom when quantitative easing by the US Federal Reserve flooded the world with cheap dollar credit.

The Indian rupee fell to a record low of 68.87 to the dollar on Thursday as foreign investors continue to pull money out of emerging market funds at the fastest rate since the China panic last August.

Traders say China's central bank has been intervening heavily over recent days to slow the slide in the yuan, fearing that capital outflows could escalate into a full blown-cascade. The currency reached a six-year low of 6.96 against the dollar on the offshore market in Hong Kong, approaching the psychological threshold of 7 RMB that could the rattle nerves of Chinese investors.

Interbank lending rates have climbed for the last eleven days in a row in Shanghai, an even longer stretch than during the 'taper tantrum' in May 2013 when the Fed first began to talk tough. Shibor rates have been spiking across all maturities.



The dollar has surged to six-year high against Chinese Yuan as capital outflows pick up again

"In our view this could be even more serious than the taper tantrum in 2013," said Stephen Jen from Eurizon SLJ Capital.

Mr Jen said higher bond yields and borrowing costs may be appropriate for America in its current particular circumstances, but they are toxic for most emerging markets still struggling with the fall-out from debt bubbles.

"The US is out of synch with the rest of the world, and under Trump there will now be an 'America First' policy so they won't to care what happens to anybody else," he said.

The core problem is that global finance is more dollarized today than at any time in history, with $10 trillion of dollar debt trading globally outside US jurisdiction and beyond full control, up fivefold since 2002.

Aggregate debt ratios are at all-time high of 225pc of global GDP, with $152 trillion of outstanding liabilities. Nobody knows how much dollar tightening the world can endure. There is no blueprint. The new system has never been stress-tested.

The Bank for International Settlements says a complex web of global hedge contracts automatically forces banks in Europe and Japan to shrink their balance sheets when the dollar rises, cutting off oxygen for emerging markets and debtor regions. This invisible process is known as the global "dollar shortage" and can be extremely powerful.

Unlike previous spasms of trouble in emerging markets, this episode has not been accompanied so far by a general flight from risky assets. Wall Street is soaring, and European equities are holding steady.

But that may be the lull before the full storm. What is clear is that pressure is building across developing Asia, Latin America, the Middle East, Africa, and even parts of Eastern Europe.

Turkey was forced to raise rates to 8pc yesterday but failed to stem the slide in the lira, which has fallen 10pc since Mr Trump's election. The country is the weakest link among the big emerging market states, under mounting trouble as the Erdogan regime eviscerates Turkish democracy and burns its bridges with the West.

Political risk has exposed the festering weakness in its economic model: a current account deficit of 5pc of GDP; short-term external debt above 108pc of foreign reserves; and a banking system funded heavily in dollars.

Mexico raised rates last week, while Malaysia, Brazil, and others have abandoned expected cuts. South Africa's central bank warned on Thursday that rising US yields were leading to a sudden stop in capital flows to emerging markets that is all too like the trauma of 2013.

China is selling US Treasuries at an accelerating rate as it runs down its reserves to defend the yuan. It offloaded $28bn in September - the most recent official figures available - and perhaps a further $14bn through proxies registered in Belgium.

Simon Derrick from BNY Mellon said we may be nearing a vicious circle where forced sales by emerging markets push US yields higher. This in turn strengthens the dollar, compelling these countries sell even more reserves, and on and on, until the system short-circuits. “There is the risk of an adverse feedback loop,” he said.

Reserve sales have the side-effect of tightening monetary policy within China. This strains the banking system, which has become dangerously reliant on short-term funding in the wholesale capital markets - with echoes of Northern Rock and Lehman Brothers.

The China Banking Regulatory Commission said this week that it had tracked down $2.9 trillion of shadow banking assets in wealth management products, and this may be just the tip of the iceberg. It described the phenomenon as “barbarian” and has imposed tough new rules to curb the abuses.

“China has the situation under control for now but the risks of capital outflows are rising,” said Mr Jen.

“In the end, the implications of Trump's protectionism are monumental. Asia's growth model is built on globalization and it feeds a whole ecosystem centered on China. This is the real worry,” he said.