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Hands Tied and Swords Bent, Emerging Markets Battle the Dollar
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By Srinivasan Sivabalan

(Bloomberg) -- The selloff in emerging markets that began three weeks ago has a disturbing undertone that makes it more dangerous than the boisterous blowout in late January.

The global “wobble” earlier this year grabbed headlines because it came with a sudden surge in volatility. But it proved to be a flesh wound, as the famed resilience of emerging markets aided a quick rebound in stocks, bonds and currencies. With the U.S. dollar losing its momentum, investors were lured again to carry-trade opportunities.

This time, however, the pain is deeper. The dollar has rallied on 17 of the past 21 days, pushing all developing-nation currencies except the ruble to hand investors negative carry returns this month. Even the mighty South African rand, whose outperformance since December has been the talking point, turned negative-yielding on Tuesday.

But that’s not the ominous undertone. It’s about how the traditional fortifications of emerging markets -- strong oil and commodity prices -- are failing to protect developing-nation currencies from the onslaught of a stronger dollar.

Look at the chart below. In January, developing-nation currencies and commodities fell together and rose back in tandem. But this time, while the Bloomberg Commodity Index is extending gains, currencies have collapsed. This divergence suggests that a strong U.S. dollar is more decisive for risk appetite than commodity prices.

That’s bad news for countries such as South Africa and Russia. The ruble, for instance, is now moving in the opposite direction to oil even though it’s the country’s biggest export earner. Their usual positive correlation was destroyed by a four-day decline in the currency in the wake of enhanced U.S. sanctions.

Risks to the Fore

There’s a big, bellowing elephant in the room.
Idiosyncratic risks are becoming more influential in currency moves, contrary to the trend seen for two years since January 2016, when yield-chasing investors helped emerging markets rise above political turbulence and diplomatic rows.

In Russia, it’s the U.S. sanctions that keeps a lid on the ruble. In Turkey, it’s President Recep Tayyip Erdogan’s economic principles that favor fighting inflation with lower interest rates are doing the lira in. Such local factors are gaining more recognition as the dollar continues to strengthen.

For the current selloff to end and emerging markets to regain their carry-trade appeal, three elements must coalesce:

* The dollar must halt its rally
* Emerging economies must take a break from self-inflicted political turmoil
* Currencies must recapture their positive correlation with commodities, especially oil

The opposite scenario, inevitably, is a massive unwinding of carry positions.

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