QNB Economics
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EM volatile amid sharp sentiment swings

Early this year, despite having highlighted a bleak picture for global growth and the persistence of political risks, we pointed out that emerging markets (EM) were set to enter 2019 on a more positive note. In fact, back then, EM were starting to benefit from powerful global tailwinds, including the US Federal Reserve (Fed) dovish pivot, the US-China trade truce, more moderate USD strength, and stabilizing commodity prices.

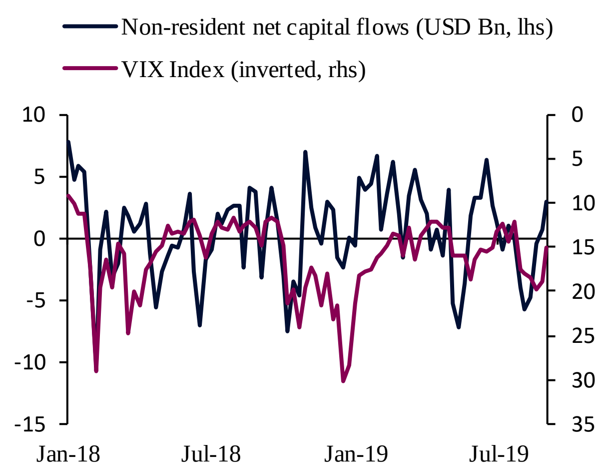
Indeed, our views have come to fruition. As sentiment improved, capital was pushed to riskier assets in general and EM assets in particular. According to the Institute of International Finance (IIF), non-resident portfolio inflows to EM increased from a monthly average of USD 16 Bn in 2018 to USD 32 Bn in H1 2019. This has contributed to significant gains across EM asset classes, including over 10% total returns in H1 for both equities (MSCI EM) and bonds (J.P. Morgan EMBI Global). However, global conditions have turned sour for EM in the summer, as sentiment suddenly shifted with additional policy uncertainty and the materialization of risks. In other words, if a risk-on environment produced tailwinds, the sudden reversal of sentiment is now producing headwinds.

In August 2019, the IIF reported USD 14 Bn in non-resident portfolio outflows from EM, the first negative figure since October 2018 and by far the worst since November 2016. Our analysis delves into the four reasons behind such sudden change in sentiment and capital flows.

First, negative developments in US-China trade negotiations severely affected risk sentiment, increasing price volatility and the overall level of stress in money, bond and equity markets. While investors are now more seasoned by the ebbs and flows of US-China trade negotiations, the last phase of escalation seems to have crystallised a more pessimistic consensus about the prospects of a trade deal. Importantly, risks of an all-out currency war started to be priced in, especially after the US Treasury designated China a "currency manipulator," following a depreciation of the CNY beyond the psychologically important 7.00 level against the USD. Risk-off behaviour favours safe-haven assets (gold, US treasuries, Japanese yen, and Swiss franc) to the detriment of EM assets. Moreover, disruptions in global trade or in China's growth are particularly threatening to Asian and commodity exporters.

Second, the positive effects of the Fed dovish pivot have been waning as US monetary authorities still support a cautious easing or "mid-cycle adjustment," disappointing more aggressive bond investors. Divergent views between bond markets and monetary authorities are a headwind for EM. Hawkish comments from Fed officials often produce negative surprises, tightening financial conditions and stressing riskier assets. As there is no consensus among senior US monetary authorities about the path of policy rates, the Fed continues behind the curve, i.e., it acts reactively instead of pro-actively. Such policy uncertainty is amplifying sudden changes in sentiment.

Weekly portfolio inflows to EM and volatility index



Sources: Bloomberg, Haver, IIF, QNB analysis

Third, the tailwind from commodity prices has already peaked, implying a further pressure on commodity producing EM through a deterioration of fiscal, terms of trade and current account dynamics. While the Bloomberg Commodity Index is still up by 2.6% so far in 2019, the overall index is very much distorted by gold, silver and crude oil prices. Precious metals are up 14% in the year as global uncertainties boost safe-haven assets. Crude oil prices are up due to a fast recovery from December 2018 lows. Commodity prices excluding petroleum and precious metals have been battered. Agriculture commodities (coffee, corn, cotton, soybeans, sugar, and wheat) are down more than 10% in 2019 while base metals plummeted by 8% from their March highs.

Fourth, a plethora of EM idiosyncratic risks emerged in recent weeks, adding to already high and increasing global risks (US-China economic disputes, global trade uncertainties, non-deal Brexit). This has amplified the risk-off behaviour and accelerated the EM selloff. EM idiosyncratic risks include economic tensions between Japan and South Korea, the economic collapse of Argentina, heightened tensions between India and Pakistan, intense protests in Hong Kong, and the French-led global environmental backlash against Brazil.

All in all, our view is that near term risks to EM continue to be skewed to the downside. US-China negotiations, the USD/CNY rates, and Fed potential hawkish surprises are the main spaces to watch. Should global risks recede in a more meaningful way, EM would benefit from a risk-on rally. However, we do not expect a material improvement in global risk conditions. Our view is that a succession of negative/positive events will continue to create volatility, generating a stop-and-go pattern for risk behaviour and capital flows to EM.

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