MARKET INSIGHTS

Market Bulletin

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What is leading the global sell-off?

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Late last week, global equities fell sharply, while emerging market bonds experienced volatility not seen since May 2013. Some press reports are blaming a weaker-than-expected January manufacturing purchasing managers' index (PMI) reading in China, while others suggest that uncertainty ahead of the upcoming Federal Reserve (Fed) meeting is the culprit. However, the markets are showing that neither of these concerns, own their own, seem to be responsible for the sell-off:

- **It's not China.** China's weak PMI number did not help investor sentiment, but if it was the main culprit for the global equity market sell-off, then we would have expected Chinese equities to fall sharply. Instead, Chinese equities rose last Friday.

Source: FactSet, J.P. Morgan Asset Management. Data are as of 01/27/2014.

- **It's not the Fed.** If global equity markets were hit by fears that the Fed will increase the pace of tapering at its upcoming monetary board meeting, we would expect to see Treasury bond yields rise. Instead yields have been falling.

J.P.Morgan
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U.S. Treasury 10 Year

Sources: Tullett Prebon, FactSet, J.P. Morgan Asset Management.
Data are as of 01/27/2014.

Rather than China or the Fed, the catalyst for the sell-off appears to be concerns over inflation and balance of payment issues in emerging markets—specifically due to issues last week in Argentina, Venezuela and Turkey. Let's look at the problems faced by each of these countries individually.

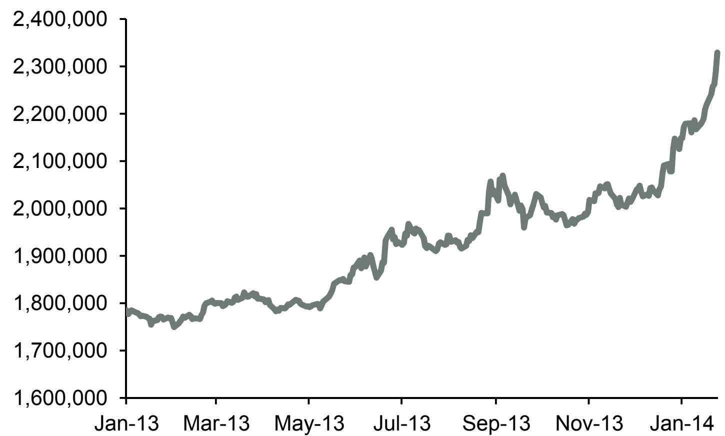
Argentina

The Argentinean peso suffered its biggest one-day fall in more than a decade late last week (-13%). The peso fell after the country's central bank decided to stop supporting the currency in an effort to preserve its reserves, which have fallen by almost a third over the past year. While it's positive that the country is focusing on preserving its currency reserves, there remains great uncertainty as to the overall intention of the Argentinean authorities for the peso, while Argentina's rampant inflation rate remains unchecked (unofficial inflation estimates are running at almost 30% year-on-year). Rapid currency devaluation without a monetary and fiscal plan for controlling inflation spells further volatility for Argentina.

Turkey

With the Turkish lira falling 6% vs. the U.S. dollar over the last few weeks (following its 20% drop last year), the country's central bank intervened directly in the currency markets at the end of last week. The Turkish central bank sold $3 billion in an attempt to support the lira, but the intervention failed and the currency continued its depreciation. The bottom line here is that the Turkish central bank does not have enough reserves to credibly mount a sustained defence of the lira for much longer than a few months, while Turkey's ongoing political drama has prevented the government from stepping in.

Turkish Lira per U.S. Dollar



Sources: FactSet, J.P. Morgan Asset Management.
Data are as of 01/27/2014.

Venezuela

In Venezuela, the government implicitly devalued the Venezuelan bolivar last week by announcing that more sectors would be shifted to a different exchange rate system under which the exchange rate is much higher than the official rate. In a more extreme version of Argentina's situation, Venezuela is rapidly running out of U.S. dollars while inflation, which ended 2013 at 56% year-on-year, is running rampant. Recent policy measures have not addressed these two main issues.

Where do we go from here?

For countries with balance of payment issues like Argentina, Turkey and Venezuela, worries over dwindling foreign currency reserves are not welcome at any time. But they are particularly unwelcome at the moment, when the emerging world is dealing with a liquidity squeeze that has, at least in part, been caused by the Fed's decision to taper its monthly asset purchases. However, this does not mean that all countries within emerging markets are dealing with the same problems (or to the same degree) as the three countries mentioned above. Nevertheless, the danger of contagion from the weaker countries spreading to the stronger ones has increased.

Even if markets begin to extrapolate these issues into a wider EM problem, **we do not believe the risk to the U.S. economy would be systemic.** There are strong fundamental reasons to expect the U.S. economic growth to accelerate over the year to come, and our central expectation is that while U.S. markets and confidence could take a temporary hit, the shock will not be a major one for the U.S. economy.

At a time like this, the key is for investors to differentiate in the EM space in order to make sure that risks and opportunities are appropriately evaluated, as they both often tend to present themselves at the same time.

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