Equity markets around the world have suffered their worst start since 2010, with the emerging economies leading the charge into negative territory. We explore the reasons for the recent rout and consider whether these "cheap" markets will become cheaper before a real buying opportunity emerges……

Signs of a slowdown in China, the global impact of the reduction in stimulus (QE tapering) from the US and the devaluation in Argentina have been widely touted as the three primary causes of the January sell-off. Investors might not have foreseen the devaluation but "China" and "tapering" should have come as no surprise**. Whilst a re-rating of EM has been on the cards for months, has it now gone too far and why have developed markets been tarred with the same brush?**

Emerging Markets: Liquidity drains away and the cracks appear

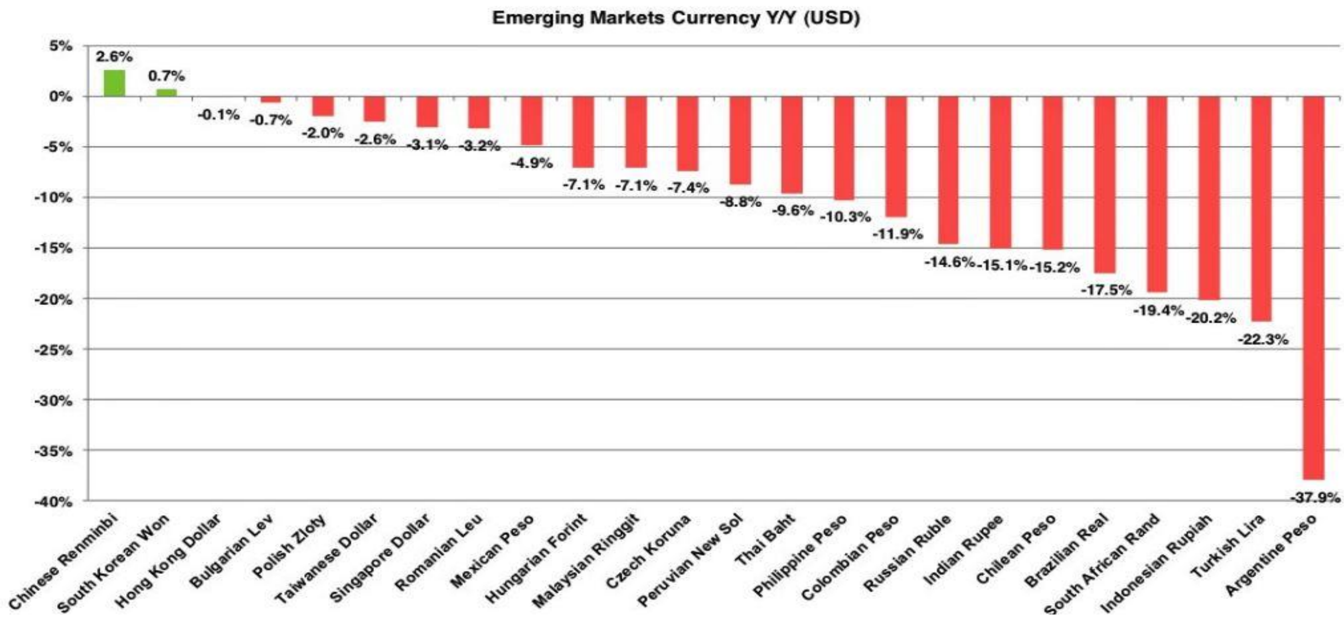
Having been lost at sea for the last 14 months, Mexican fisherman Jose Salvador Alvarengo can be forgiven for being blissfully unaware of the Federal Reserve's announced intentions to withdraw monetary stimulus from the US economy (May 2013). He can therefore also be forgiven for not expecting the most recent QE tapering announcement from the Federal Reserve, which has slashed QE by a further $10bn a month. However the rest of the world doesn't really have his excuse and **whilst this latest Fed action has been very well sign posted, judging by the market's reaction, the news seemed to take most investors by complete surprise.**

The decision to further taper QE was announced last Wednesday, however the sell-off commenced exactly a week earlier, after **Argentina shocked the markets by announcing a devaluation of the Peso against the US Dollar**. This is because the unofficial inflation rate in Argentina had been running at about 28% last year and interest rates, at a staggering 26%, are still negative when taking this inflation into account. **No wonder then that the locals have been bailing out of Pesos and into safer US dollars**, to such an extent that Argentina's foreign currency reserves were reduced to $29bn, as the bank tried in vain to support the ever weakening currency. According to Bloomberg, **Moody's Investors Service believes that Argentina may devalue the currency by up to another 50 percent before the year is out.**

It was this news that started the market rout and the currencies of the weaker emerging market economies (such as Turkey, Brazil, India, South Africa) plummeted in response as investors feared devaluations in these other struggling economies.

This bad news was then exacerbated by data confirming that the Chinese economy was starting to slow down (mainly due to poor manufacturing data) and this further weighed on sentiment. **The US announcement about further tapering was simply the final nail in January's coffin**, most notably because the Argentinian devaluation and slower growth in China can be attributed at least in part to this Federal Reserve tapering action. **A stronger US dollar means debt repayments increase for these countries. Also, capital repatriation from EM to the US caused by the withdrawal of stimulus (QE tapering) triggers further sales of equities and bonds** in the affected regions (see various market summaries that we have produced over the last year or so).

The World Bank believes that nearly a quarter of developing countries could experience an immediate cessation of their access to global capital, throwing some economies into a balance of payments deficit.



EM Currencies catch a cold from Argentina

If you've read any of our last few market reviews then it will come as no surprise to you that **we have advised our clients to have little or no exposure to emerging markets for a long time**. But whatever sense of temporary smugness we might have felt having made this correct call has been obliterated by the chain reaction into our favoured equity markets – US, UK and Japan.

We expected that there might have been some negative reaction to the weakening story in EM but we think that the developed markets have been oversold.

Yes, **Sterling and the US dollar have been major beneficiaries of the flight to quality**, **but this positive move has been tempered by the fall in the value of the S&P 500 and the FTSE 100**, even if relatively these falls have been less pronounced than in China and other emerging markets.

Is it justified that developed markets should be dragged over the cliff by EM weakness? In the short term this is an irrelevant question because when there is strong momentum behind a "risk-off" trade then all markets suffer to a greater or lesser extent.

The more important question relates to whether this EM driven rout will continue to indiscriminately affect developed markets or whether this is in fact a "buy on weakness" moment. To address this we must firstly consider whether or not there might be further falls in emerging markets.

Sentiment is weak and in a momentum driven sell-off such as this there is plenty of room for EM prices to fall further, even if valuations are now looking attractive.

The fundamentals depend on improving data from China and re-assurance that more rounds of inevitable QE tapering will not cause more damage to already fragile EM currencies. The Chinese are the most able of any of the world's economies to pull the massive monetary levers required to turn their "growth stall" around so this doesn't overly concern us. **However the impact of further QE on the other EM currencies is of far greater concern** and needs to be carefully monitored.

Therefore neither sentiment nor fundamentals gives us great cause for optimism in the short term.

The other major factor to consider is the effect of ever increasing outflows from EM caused by retail and/or institutional investors continuing to exit these markets. **We believe that this negative flow will not stop in the short term.**

However it is this last point that gives us optimism about the prospects for some of our more favoured markets.

Huge capital flight from EM means that **investors have to invest into other equity markets with better growth prospects** or hoard cash, gold or US Treasuries.

Has the tide turned? Huge EM inflows become outflows in 2013

Source: Economist

Cash might be a short term home but offers no yield, gold has picked up but is sensitive to further taper talk and whilst US and UK government bond yields have been squashed again in the inevitable flight to quality, there's not much value in holding government bonds in the long term when interest rates do eventually rise, although admittedly this will be some time away.

Hot money flowing specifically out of EM equities is unlikely to be generally rotated into a different asset class and so **the inevitable longer term home for at least a proportion of this capital is into developed markets such as Europe, the UK and the US.**

This should support the case for owning the US dollar and GBP particularly and rewards longer term holders of developed market equities generally.

However **the main case for continuing to support developed market equities is the relatively positive fundamental outlook for the UK and US economies compared with their EM counterparts.** Regardless of the short-term implications of the sentiment driven decline, the balance has temporarily shifted back to these developed markets.

We're much closer to feeling comfortable about dipping our toes back into emerging economies but fear that bearish momentum will continue to unsettle these markets in the short-term.

Our advice is to keep some "powder dry" for a better opportunity to buy into increasingly good value emerging markets and to hold on to your developed market exposure after a sentiment driven decline.