"………. we only have a mandate to concern ourselves with the interest of the United States," so says Dennis Lockhart, president of the Atlanta Fed. **"Other countries simply have to take that as a reality and adjust to us if that's something important for their economies."**

Investors have had only one thing on their minds over the last three months - the prospect of quantitative easing (QE) being 'tapered' by the US Federal Reserve (FED). It was first announced back on 22nd May this year when the FED indicated that it would begin the "tapering down" of its $85 billion a month asset purchasing scheme as early as September 2013, akin to taking its foot off the accelerator, rather than applying the brakes. This deadline is now imminent and investors wait with bated breath for Bernanke's announcement on the 17th of this month because the prospect of an end to an environment of ultra-cheap borrowing now seems inevitable.

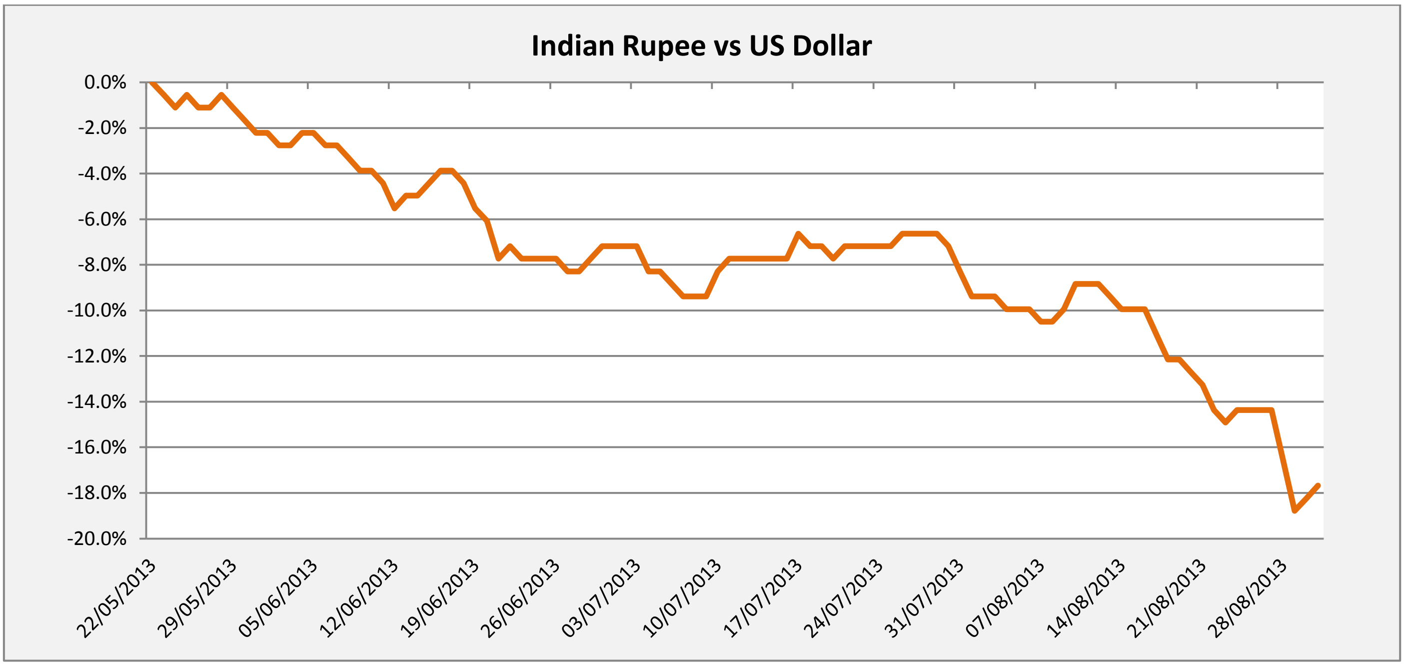
As a result, August has been a volatile month for equity markets and this week the 'Vix index' which is a measure of **volatility in equity markets** - often referred to as a 'fear gauge' - **hit its highest level for almost 3 months.** Developed market equities have suffered with both the UK FTSE 100 and the US S&P 500 recording monthly falls of 3.1% as of close of play on Friday. However, **the biggest loses have been felt in the emerging market (EM) economies**, epitomised by the plunge in both the Indian equity market and also the demise of the Rupee (down 8.8% over the month – the biggest monthly fall since March 1992).

As it is the single most important factor influencing markets today, **we make no apology for continuing to focus on QE and the specific impact that its proposed reduction has on the emerging markets**. We take a look at these fragile economies, trying to isolate the fundamentals behind the aggressive sell-off in both their currency and equity markets and also to determine whether or not we are now seeing a real opportunity to take advantage of these undervalued regions. We will use India as an extreme example of how an end to QE can impact an economy dependent on dollar based imports and debt.

Emerging markets have been the biggest beneficiaries of the FED's QE programme as US investors who sold their treasuries invested heavily in emerging market economies that were offering relatively attractive yields. In addition, lower yields in the US meant that it made sense for emerging market governments to borrow more dollars to invest at home rather than borrow at home at much higher rates.

They could even use this cheap source of capital to help finance the purchase of imports and with their domestic currency appreciating against the dollar, those imports were becoming ever cheaper – a seemingly virtuous circle. A virtuous circle that will quickly turn volte face when the FED removes the punch bowl, reverses QE, rates increase and the US dollar appreciates, which is exactly what we are now starting to see.

Not only do rising bond yields in the US strengthen the US Dollar, in turn a stronger dollar and therefore falling EM currencies means that **EM countries like India are now "importing" more inflation** as imports become more expensive in foreign currency terms. As a result**, investors fear that some EM countries could slip into a dreaded state of 'stagflation'**, where their economies experience falling output - on the back of lower demand – and yet higher prices.



So with such a risk to emerging economies, why would the US end QE now? **The US treasury has made it very clear that controlling the growth rate of the US economy is their only major consideration** (see quote at the beginning of this note) **and if emerging market economies that have borrowed too much in dollars get trampled in the process than that's just tough**. Ironic and slightly hypocritical really, given that it was not long ago that the US repeatedly expressed contempt for China manipulating its own currency to satisfy its own domestic growth prospects.

We believe that an end to QE signifies strength in the US economy, and although it may spook global markets in the short term, fundamentally, **it is a sign that at least the US is on the right path to recovery.**

So what's the damage? **Investors have withdrawn a total of $20 billion and $26.5 billion from emerging market bond and equity funds respectively in the three months to August 21st.** This represents a 'flight to safety' amid continued fears that growth has stalled in EM economies and that developed markets such as the US and now Europe are continuing to show positive signs of recovery.

This capital flight is exemplified by the rout in Indian markets and currency which culminated in India's prime minister Manmohan Singh gathering with his most senior of economic policy makers in Delhi where he declared that India faced "very difficult circumstances". This huge understatement comes just two years after Mr Singh announced that India's growth rate of 8-9% was its new cruising speed and that there would be an end to chronic poverty, ignorance and disease throughout the country.

Today, India is facing its largest financial crisis since 1991 when it was forced to airlift 47 tons of its Gold reserves to the Bank of England just to secure enough funds to cover its most essential weekly imports. Fear of a mass exodus of foreign and domestic capital led the Indian government to cut the amount that Indians can take abroad annually (under the "Liberalised Remittance Scheme") from $200,000 to $75,000 and markets reacted aggressively to the obvious smell of fear, selling equities and ditching the Rupee.

The Rupee is now at an all-time low against the US dollar, having fallen 8.8% in August alone, its biggest monthly fall for 21 years and with the prospect of an impending war with Syria, the resultant oil price spike saw brent crude hit a six month high of $117.34. India imports at least 80% of its oil needs and the shock in oil prices has added further pressure to an ever larger deficit in its balance of payments.

With the Rupee at such low levels the Indian government has begun eating into foreign capital reserves as a way to fund its growing import bill along with its rising foreign debt payments. With yields rising in the US, servicing these debt payments will continue to deplete foreign capital and at an ever increasing rate as the cost of borrowing rises. **India currently has enough foreign capital to cover its current-account deficit and outstanding debt for the next year, by which time it will have mostly depleted its reserves.**

India is perhaps the most extreme example of what is happening across many other emerging economies at present. Mexico, Indonesia, Thailand and Brazil amongst others have all suffered capital flight, falling currencies and weakening reserves. **Whilst the initial knee-jerk reaction to the threat of QE tapering was always going to be severe, we fear that there could be further slow seepage in EM over the months ahead as the threat becomes a reality**. The key will be how the FED manages the markets' expectations about the pace of tapering and it certainly doesn't help that we don't yet know who will be replacing Bernanke as Federal Reserve chairman.

So, where do we stand? Our clients currently have no exposure to emerging markets such as Latin America and very little exposure to Asian equity. We rotated earlier this year into developed market equities in the US, UK and Japan with an emphasis on the US. Whilst US equities are not looking cheap on historic valuation metrics, further strength in the US dollar, repatriation of assets back to the US and a strengthening US economy, should all prove supportive for US companies and this has been the right positioning over the last six months.

However unlike in the Asian crisis in 1997, we do recognise that these emerging economies are in better shape this time around. We also recognise that there will be an incredible buying opportunity for EM equities and bonds, and whilst we may miss out on the first 5-10% of such a rally, this is preferred to investing too early and possibly participating in another significant leg down. **We'd rather wait until the knife hits the kitchen floor than try to catch it on the way down.**

Source: Economist