Nowhere to hide

Equity markets had enjoyed an unprecedented rally up until the 22nd May 2013, with the FTSE 100 within 150 points of touching its 1999 all-time high and the Nikkei and S&P 500 soaring. However, with Fed Chairman Ben **Bernanke's testimony on that Wednesday afternoon** hinting that quantitative easing will be phased out soon, this changed the outlook considerably and **led to an immediate sell-off** that has rattled investors ever since (see our June Overview). From peak to trough world markets have fallen between 7.32% (US "S&P") to an eye watering 24.61% (Brazilian "Bovespa"). Over the same period bonds, gold and other "defensive" assets, typically seen as "a hedge" in times of fear, have also fallen considerably as the table below demonstrates.

This month we explore why **almost every asset class apart from cash has suffered in the recent sell-off**, including those that would ordinarily have acted as a safe haven in times of severe market stress. **Secondly we identify a potential silver lining in the current storm clouds.**

Emerging markets, including Latin America and Asia, **have been the hardest hit since the market rout began.** This is because they were the most significant beneficiaries of the Federal Reserve's (FED) quantitative easing programme in the first place. Countries such as China have relied upon a buoyant commodities market and have benefitted from massive capital inflows as a result of rising prices. Also, the Fed has printed money and used it to buy US bonds, making them more expensive and unattractive in the process. The **sellers used that money to buy other bonds and investments that pay a higher income** and **emerging markets, that typically pay the highest yield, were major beneficiaries as a result.**

Also, ever since the 2008 Financial Crisis, **investors have sought to invest in emerging markets as a way of diversifying** away from heavily-indebted US and European economies. This "hot money" poured into emerging market equities, property and currencies.

The Fed's plan to remove "the punch bowl" (or to water it down it at least) **has led investors to rush for the exit from emerging markets**, reversing an enormous flow of capital, on fears that a stronger US dollar will weaken emerging currencies whilst also increasing borrowings in US dollars that for so long have been used to invest back into emerging market economies. **It also hasn't helped that the central bank of China hiked short term lending rates** in an attempt to stop out of control lending from regional banks, leading to further outflows from the region.

Other equity markets have not been immune, with developed market equities falling over fears that reducing QE in the US will ultimately lead to the same fate at home.

In Japan, where massive QE will continue for the foreseeable future, profit takers stepped in anyway after a very strong period of stock market growth in the region.

Losses across the board - May 24th to June 24th

Bonds	
Emerging Market Bonds	-11.02%
UK Government	-2.05%
Convertibles	-7.04%
High Yield US	-6.72%
UK Government Index linked	-2.74%
UK Corporate Bonds	-2.19%
High Yield Global	-5.04%
Average Loss	**-5.26%**
Equity	
FTSE 100	-11.39%
S&P 500	-7.32%
Nikkei 225	-12.23%
Hang Seng	-16.58%
Bovespa	-24.61%
Average Loss	**-14.43%**
Other Investments	
Gold	-11.20%
Hedge Funds	-9.95%
Multiasset Class	-5.65%
Average Loss	**-8.93%**

In general then, **equities have reacted very badly to the news that QE will ultimately be reduced** sooner than first expected.

So what about government bonds? **Investors typically buy into government bonds when fear sets in**, as panic selling creates a "flight to quality".

Not so this time around because government bonds are already overpriced. In fact, **the threat of unwinding QE has led to government bonds actually falling**, as investors fear that governments will start to sell these bonds back into the market over time and in addition the fear of interest rates rising has knocked bond prices further.

Gold has also suffered over the quarter, driven by **dual fears that both the US dollar will continue to rise as a result of QE tapering and by concerns that slowdown in emerging markets will impact demand.** Ironically the potential for inflation in the US should lead to gold at least offering some protection but this has not stopped loss cutting by many investors who perhaps have a shorter term focus.

Also most hedge funds were caught out by the timing of Bernanke's comments and by the severity of the decline. Funds that had positioned themselves for continuing and extended QE whilst also participating in Japan's on going rally, felt the squeeze as all major asset classes fell.

So there has really been nowhere to hide in the current sell-off, with the exception of those with a reasonable proportion of cash. Investors who were able to take some profits and hold these on the side-lines ready to re-invest would have weathered the storm in the short term. Even though not really generating much in the way of return, **holding cash as a tactical position rather than a longer term strategy has certainly helped.**

So what to do with cash once the markets settle down?

3 positive factors come out of the current situation:

1) There is a massive difference between reducing QE and removing QE altogether

2) Tapering QE comes as a direct response to improving conditions in the US economy, the engine room of world growth

3) Tapering won't even start until there are sure signs of this recovery (falling unemployment)

Expanding on the points above, Bernanke has suggested that **the Federal Reserve will slowly take its foot off the accelerator,** not put its foot down hard on the brakes. Instead of buying $85bn of bonds a month they will initially reduce this to $65bn a month, which should help to stop the truck slowly.

Secondly **the Fed acted ahead of time to warn the markets** about reducing QE because they know just how dependent investors have become on cheap money.

However to put this warning into the public domain**, they must surely expect that the US economy is on the verge of recovering.** This should be seen as a positive sign for the US.

Finally it has been decreed that **the Fed won't act until the expected recovery actually becomes evident**, which means that they still have the option to carry on printing if economic recovery does not materialise.

These factors should all help to manage the market's expectations of how an orderly exit from QE will be handled and to us this news suggests that the US market is most likely to benefit.

As the economy recovers and company profits increase, US stocks could be major beneficiaries. Likewise as the US dollar strengthens due to potential energy self-sufficiency and a growing economy, investors from overseas who are buying US companies will benefit from that currency appreciation.

Summary

Investors should not lose sight of the main reason that the Federal Reserve has intentionally warned the markets that QE will ultimately end. It is predicated on the fundamental belief that the US economy is recovering.

If we do see further recovery in the US then this is good news in the longer term.

If we don't, then the Fed will carry on printing $85bn a month until we do.

Either way the outlook for the US and indeed the US $ is improving, but investors should be wary of the effect on the emerging market economies as a result.

How have we reacted?

We are increasing exposure to US equities and reducing our exposure to higher risk emerging markets. With concerns over Brazil in particular, we sold the majority of our Latin American equity exposure a few months ago.

We will continue to reduce exposure to emerging markets and re-invest into developed market equities, topping up exposure to Japan where we believe that continuing QE will further fuel the domestic recovery after a dramatic pause for breath.