CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

February 3, 2014

Tremors in Emerging Markets
Spill over to Developed Countries

After a fine year for stock markets in the United States, Europe and Japan in 2013, markets stumbled in January. In particular, most emerging markets--that is, the stocks, bonds and currencies of developing countries--fell sharply. This turbulence raises fears that crises in emerging markets could cause selling in developed markets, where stock markets rose so briskly last year.

Apart from emerging markets contagion, economies of developed countries face several other risks as 2014 begins:, including the Federal Reserve's beginning in January to cut its rate of asset purchases (the 'taper'), the specter of deflation--falling prices; and stagnant economic growth (arising from weak demand in the private sector (households and companies) and fiscal austerity on the part of governments).

Changes at the Fed. After several years of expansionary and radical monetary policies at the Fed, we are probably in early stages of the process of 'normalizing' monetary policy. As Janet Yellen begins her role as chair of the Fed, the Fed will probably continue to reduce the rate of its asset purchases and, in time, to bring them to an end. Then, should the economy continue modest growth, the Fed will probably start to raise short term interest rates, which for more than five years have been essentially zero. These Fed actions will be consequential. Note that the Fed's aggressive monetary policy commenced in 2008 as the financial crisis began served two principal functions: firstly to prevent the collapse of the financial system, and secondly to stimulate economic recovery by supporting prices of real estate and financial assets. The withdrawal of monetary support may adversely affect financial markets and the real economy.

The risk of deflation is especially acute in Eurozone, where the year-over-year change in consumer prices is alarmingly close to zero (0.8%) and well below the target rate of inflation, defined there as 'close to but below' 2%. Christine Lagarde, the head of the International Monetary Fund (the IMF), has recently begun to warn of the problem, noting that central bankers are wary even of using the term 'deflation' for fear of the self-fulfilling consequences of discussing it. We may expect the European Central Bank to expand its monetary policies if deflation risks rise further. The Eurozone recession has come to an end and modest economic recovery is underway. With the exception Greece, the hard-hit 'peripheral' economies, including Spain and Italy, are growing, although unemployment remains extremely high in those countries, especially for young people.

By

Jack Mayberry

Stagnant economies in the developed world seem increasingly to be the rule. The United States is several years into recovery from the Great Recession, but demand is low and wages are not rising despite modest job growth. Because jobs being created are often part-time and ill-paid, economic activity is stuck at a low level, without the vigor that we would expect after such a recession. As we have discussed several times before, Japan is taking forceful steps of co-ordinated monetary and fiscal expansion in a concerted effort to bring an end to the deflationary period stretching back well over a decade and to stimulate economic growth. It is far too early for the Japanese to declare victory, but the actions are likely to provide further support for Japanese stock market.

Spillover effects from Turkey. Because of deflation risks in Europe, the still-unresolved sovereign debt crisis there, and paltry economic growth, the new currency crisis in several emerging markets threatens Europe's economy and its financial markets. Turkey is one of the countries whose currency has declined most sharply. Poor Cyprus and Greece, ravaged in the eurozone crisis and slowly rebuilding in tourism. Turkey's much devalued currency is likely to crush tourism in these countries, which, burdened with the strong euro, can hardly compete against their Eastern Mediterranean neighbor. Emerging market currency crises have created severe problems in developed countries in the past--recall 1998. In this context, the volatility and selling in US, European and Japanese markets in January is unsurprising.

Despite January's declines in stocks--3.6% in the S&P 500, 3.4% in the UK, 1.9% in Europe, and 8.5% in Japan--these markets are likely to appreciate this year, as the underlying economies in these developed markets grow modestly. Stock markets are vulnerable to a bout of selling, not having experienced even a 10% decline since the summer of 2011. We raised some cash in Core's clients' accounts in January by selling a position in French stocks. We expect to wait until this turmoil runs its course, and then to make a further equity investment in one of these developed market countries.

Strength in bonds. Apart from substantial investments in stocks in these markets, we also have meaningful bond investments. For these investments, the deflation risk and sluggish economies are a boon and cause prices to rally. Our US bond investments rose in value in January. The benchmark ten-year US treasury bond yield fell from about 3% to 2.7% as January ended. Further reports of slowing economic activity and declining inflation will drive the bond prices up and yields down. Our bond investments and the cash we hold now provide a cushion as the market attempts to find sound footing again.

CORE Comments

CORE ASSET MANAGEMENT

PO Box 1629
108 Caledonia Street
Sausalito, California 94966
(415) 332-2000 • (800) 451-2240
fax (415) 332-2151
www.coreasset.com
info@coreasset.com