Investors cautious on markets as risks grow

We have seen quite a dichotomy in financial markets since early summer. A number of large emerging markets have been characterised by a series of crises, with plunging currencies, soaring interest rates and declining stock markets, often against a fraught political backdrop. Some emerging market stock indices are down more than 20% from their January highs, the typical definition of a bear market.

A strengthening of the US dollar and tightening of monetary conditions, as interest rates rise and QE is wound down by central banks, are often cited as the cause of the difficulties in emerging markets. However, this misses the point.

In reality, the rising dollar and higher rates exposed deep problems in many emerging economies in terms of economic mismanagement, very high levels of external debt, unsustainable fiscal policies and large balance of payments deficits.

Interestingly, even though the dollar lost ground in late August, the situation in some emerging economies continued to deteriorate, most notably Argentina, Turkey and Venezuela, which are all in the grip of a serious economic and financial crisis. Meanwhile, some signs of slower growth in the Chinese economy have added to concerns about emerging economies, especially those with a high dependence on commodity exports.

If chaos has been the order of the day in many emerging markets, range trading has been the main feature in most developed markets since early summer. One can't deny that escalating trade tensions and increased geo-political risks, as well as the problems in emerging markets, have given rise to bouts of risk aversion and flights to quality in financial markets.

Currencies like the US dollar, yen and Swiss franc have benefitted from such flows, as have the main government bond markets. Generally though, the main bond markets, most equity market indices, with the notable exception of strong US stocks, as well as key exchange rates have been confined to relatively narrow trading ranges in recent months.

We have seen solid economic data and a further tightening of monetary policy over the summer, including rate hikes in the US and UK, as well as good corporate earnings. It is probably fair to argue that stock markets should be higher and bond yields would have risen but for the difficulties in emerging markets, as well as the uncertainty caused by escalating global trade tensions and increased geo-political risks.

Investors have taken to the side lines, though, and are adopting a very cautious approach as they wait and see how current events pan out. The difficulties being experienced by some of the larger emerging economies are unlikely to subside anytime soon, as they are deep seated problems that will take some time to resolve.

The question is whether stock markets in developed economies will continue to be able to withstand a contagion from the sell-off in emerging markets. There have been some signs in the past fortnight that stock markets are coming under pressure from contagion effects, especially in Europe. Ongoing tensions over global trade may also be a factor.

However, economic data are holding up quite well. The latest figures suggest that the US economy has continued to grow at a robust pace in the third quarter, with European economies still expanding at a solid rate. Nonetheless, investors are likely to remain cautious given the mounting downside risks to the global economic outlook.

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