

Research

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Emerging Markets: It ain't over till the fat lady sings

- The Emerging Markets' sell-off has continued overnight and it is still far too early to say that this is over
- It should be noted that there has not been any significant policy or macro economic trigger behind the sell-off in Emerging Markets
- ...it is simply a matter of too many Emerging Markets assets being too expensive and overvalued
- Therefore the sell-off could persist for some time to come
- The extent and length of the sell-off is hard to predict, but this could be the initial phase of a sell-off and we therefore clearly recommend to reduce exposure to Emerging Markets - particular in high-beta/high-carry markets like Turkey and Brazil and Central and Eastern Europe. Emerging Asian FX markets look like the only safe haven in Asia and even here exposure to the high-yielders should be reduced.

This is reason to worry

...and it might just be the beginning

The sell-off in Emerging Markets has continued overnight, and it may be more than a minor correction. Asian equity markets are tumbling, especially the high beta ones such as the Indonesian and the Philippines whereas Asian high-yielding currencies such as IDR and PHP have suffered.

Overnight Thai Finance Minister Pridiyathorn Devakula has resigned citing intense media criticism of his performance. This adds to the political uncertainty in Thailand which is not good news for the Thai markets.

The Chinese equity market has stabilized overnight. The most important triggers behind the nervousness in the Chinese equity markets are 1) increased anxiety that the Chinese policymakers will impose further monetary policy tightening in the aftermath of the National People's Congress, which will last from Mar 5 - Mar 16 and 2) profit taking from investors in a market, which is up by close to 140% since the beginning of 2006. Further downward correction of the Chinese equity market appears likely.

The sell-off in the Asian markets came after a bloody US session where the US equity market sold off spreading to the Latin American markets. In-

deed the sell-off has been broadly based geographically and between different asset classes: equity markets are suffering; high yielding emerging market currencies such as the usual suspects like TRY, BRL and IDR are weakening mirrored by a significant strengthening of the funding currencies, JPY and CHF. Bond markets have gained indicating safe heaven flows from equity markets. This may not just be another minor correction and should, in our view, not be seen as a buying opportunity - at least not yet.

In many ways this looks very much like the sell-off we saw in early summer last year. However, it is notable that this time the sell-off comes at a point where global bond yields have been falling for a while, and therefore have supported Emerging Markets, while the traditionally funding currencies CHF and JPY have continued to weaken until yesterday's sharp turnaround. This time around the trigger did not come from a monetary policy event - like a tightening of monetary policy conditions from the BoJ or the Fed - the rise in risk aversion comes out of the blue. Instead, we interpret the turnaround as a mis-valuation crisis - too many assets have simply become far too expensive.

Nobody knows how long this sell-off will continue or how large it will be, but we stress that there are very few "cherries" to pick out there - at least not many cheap cherries. It will thus be much harder to avoid getting caught in the sell-off since most Emerging Markets look overly expensive - with most of the Emerging Asian currencies as the only real exception.

In the emerging market universe some markets look extraordinary vulnerable. We especially point to the Central and Eastern European markets, which in general look overvalued - both the FX and fixed income markets - and the high-beta/high-carry markets, which are normally very sensitive to rising risk aversion. We especially advise caution in regard to the Turkish and Brazilian markets that since last summer have rebounded strongly - too much in our view. Most Asian currencies are still relatively cheap with the Indonesian rupiah marking the only real exception. We still have a negative view on the yen due to the BoJ not being able to catch up with the other major central banks. But with global risk aversion back in the game it could strengthen further before weakening again.

In all this could be the beginning of a continued sell-off and we strongly recommend reducing exposure

to the riskiest markets. Remember that most of the high risk emerging market currencies have still only lost 3-5% in this sell off. Sooner or later we will reach a point where buying opportunities will emerge in Emerging Markets, but we may still have some way to go. As an example remember that the Turkish lira lost near 30% against the major currencies last year from peak to bottom.

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