



Market Flash

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BRIEF COMMENTARY ON THE FEBRUARY 27TH EQUITY MARKET SELL-OFF

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A wave of market jitters swept the globe this week, a bit reminiscent of the events that started the Asian financial crisis in 1997. Major equity markets lost between three and five percent on Tuesday, February 27, and emerging market stock indices were hit even harder, losing between five and eight percent. A computer problem at the New York Stock Exchange led to a sudden 250 point drop in the afternoon and added to the nervousness among investors. The main beneficiary of the global equity carnage was the U.S. Treasury market, as investors reached for safe-haven assets. Among the major currencies, the Japanese Yen had the biggest one-day gain against the U.S. dollar in 14 months, while a number of major emerging market currencies such as the Brazilian Real and the Turkish Lira fell sharply.

The wave of selling started in China on Tuesday morning on concerns of government action to curb speculation in Chinese stocks, which had driven the market up 121 percent last year. The reassessment of such apparently overvalued positions compelled many investors to close out other trades that had performed well in recent months. The bearish mood among investors was amplified by comments by former Federal Reserve Chairman Alan Greenspan that the U.S. economy might face a recession later this year and by U.S. economic data that questioned the strength of the current growth backdrop.

Comparing this episode with other instances of sharp equity market sell-offs suggests that neither the fundamental nor the valuation backdrop justified such drastic price action. Global economic fundamentals still primarily support the outlook of solid equity market performance for 2007. The most recent round of U.S. economic data has indeed been weaker than expected, yet we maintain our view that growth will pick up in the coming months as the headwinds from housing and weaker business investment fade. The outlook for European economic growth remains bullish, driven by improving labor markets and strong export demand. In most Asian economies, the majority of forecasters predict continued strong growth.

With central banks around the world generally on hold or on a very gradual tightening path, policy rates are still stimulative, which indicates that there is little risk to financial markets from an overly aggressive monetary policy. Real long-term bond yields, however, are still well below long-term averages, suggesting that bonds in general and U.S. Treasuries in particular continue to appear overvalued at their current yield levels.

The increase in growth risk in the United States may have warranted a consolidation of recent equity market gains but not a sharp revaluation of stocks globally. The last major sell-off in May of 2006, for example, was driven by fears that stronger growth, and more importantly, faster inflation would force the Federal Reserve to raise interest rates beyond what financial markets had priced in. Today, the risks seem to be the opposite, in the form of weaker-than-expected growth and potentially supportive interest-rate cuts. Unlike the 1997 Asian economic crisis, the rest of the world seems in much better shape today, as many economies are running current account surpluses, currencies are generally free floating, and fiscal deficits much less of a burden.

The indicators that recently signaled serious imbalances were the surveys of investor positioning, which showed a significant increase in the past six months in 'carry trades,' in which investors borrowed funds in currencies with low interest rates (mostly in Japanese Yen) and invested those funds in currencies with significantly higher short-term rates, such as the New Zealand dollar or Brazilian Real. The risk of weaker global growth and narrowing interest-rate differentials drove many investors to close their carry positions, which led to the sharp Yen appreciation.

Bottom Line: This week's equity market sell-off was a stark reminder that low market volatility is no guarantee against share price movements. The size and speed with which international capital can react to even small changes in the generally accepted market consensus has increased dramatically in recent years. In addition, the prevalence of momentum investors, such as index funds and carry trades, increases the risk of amplified market moves. Today's calmer markets, despite further bearish U.S. economic data, support our view that market technicals had been the main driver of the correction. We don't expect an immediate return to the status quo ante. However, more convincing evidence that the U.S. economy remains on a moderate growth path, which we expect to see in the coming months, paired with attractive market valuations should allow stock indices to climb back into positive territory, validating solid return expectations for the full year. ■