“Black Monday” at the stock exchanges: Why?

Gerhard Winzer

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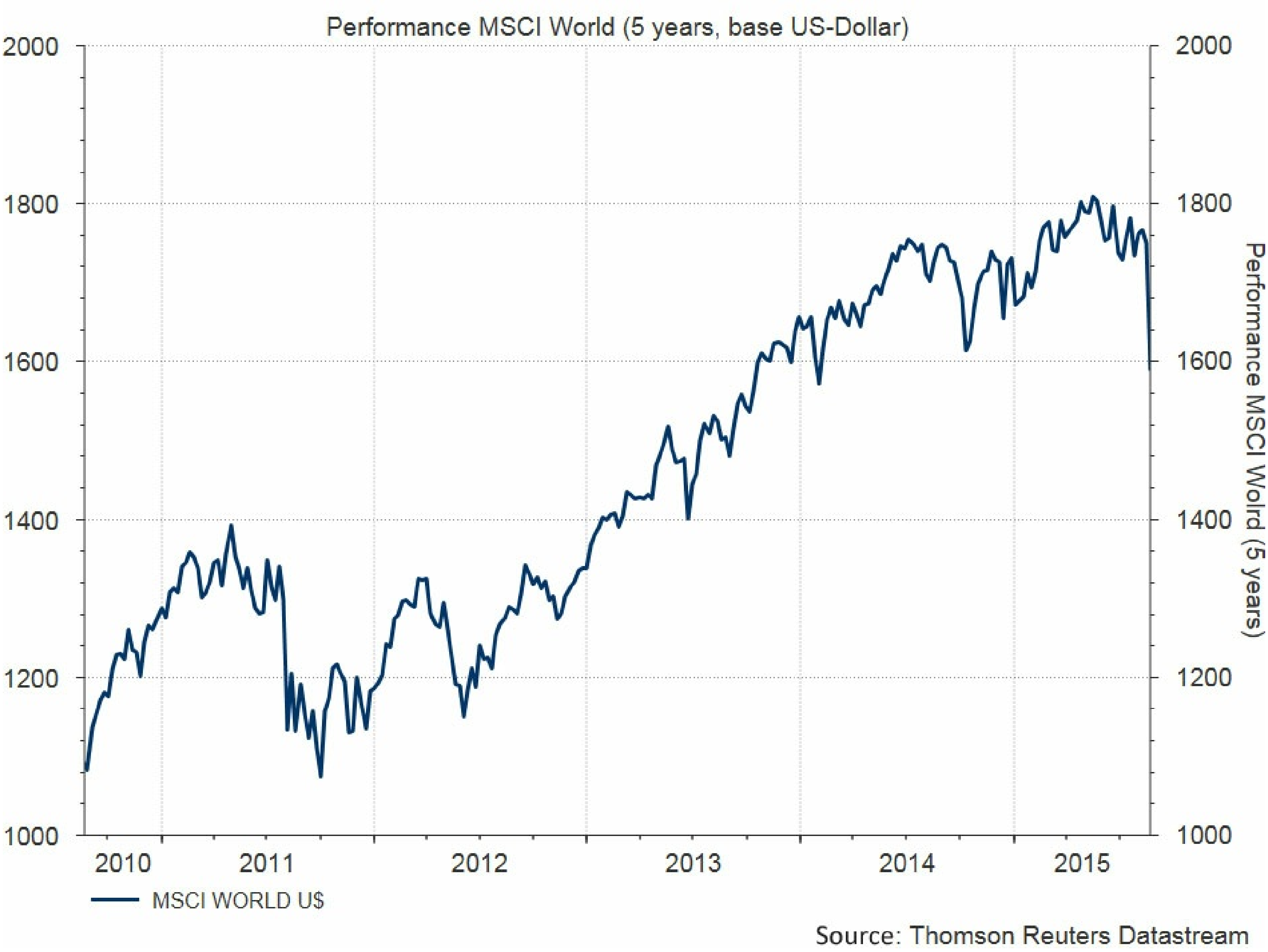
Market correction

Equities, bonds affected by default risk,commodities, and emerging markets currencies are currently subject to corrections, which, noticeably, have now gone beyond the purview of emerging markets: while the emerging markets equity index declined by almost 6% (Performance-Data Source: Bloomberg, MSCI) last week, the index for developed markets lost 5.3% (Performance-Data Source: Bloomberg, MSCI). The fear that the economic weakening in the emerging markets might come with significant spill-over effects for the industrialised countries has increased. This prompts the question whether a phase of profound corrections is upon us in the risky asset classes. The question alone has caused the risk aversion of investors to rise. The liquidity is temporarily parked in safe havens such as US Treasury bonds, the euro, and the Japanese yen.



Devaluation of the renminbi

The most recent price declines were triggered by the devaluation of the Chinese currency relative to the US dollar of more than 4% on 11 August. The markets did not only see the positive effects such as the emancipation from the US central bank and from the US dollar and a more flexible currency but also the possible negative effects such as a devaluation race. The uncertainty alone over how much the renminbi will depreciate has caused depreciation pressure and actual depreciation among emerging markets currencies. At the moment the Chinese currency is about 3% below the exchange rate that had been set by the Chinese central bank on Friday. It would be a comforting signal if the central bank were to intervene and keep the exchange rate stable.

Increase of the Fed funds rate

The market corrections were exacerbated by the expectations of imminent raises of the Fed funds rate in the USA. This underlines the diverging development in the developed and the emerging markets. It makes sense to argue in favour of the key-lending rate to exceed zero percent in view of an unemployment rate of 5.4% in the USA. That being said, the policies of the US central bank are not only relevant for the USA, but also for the global economy. The rising deflationary pressure coming from the emerging markets would certainly go better with monetary loosening than with tightening. Indeed, the inflation expectations priced into the market have already fallen drastically.

Negative spiral

Meanwhile a spiral has been set off: price declines cause capital outflows and a decline in risk appetite. This in turn triggers price declines. In such an environment arguments based on valuation are of little relevance. Calming signals from the Chinese and the US central bank would help the situation, as would additional stimulus packages in China (a cut of the key-lending rate, public investment). However, the economic environment in the emerging markets will remain weak. We can only hope that the deflationary forces on the developed markets will remain in check. At least the most recent indicators in the industrialised economies such as the purchasing managers indices in the Eurozone have suggested continued growth slightly above potential. In the meantime nominal, credit-safe government bonds are the only ones to offer protection against capital losses.

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