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Orderly retreat?

The developed nations led by the world's largest economy, the US, have started 2014 in conditions that few would have expected a year ago: economic recovery that looks stronger by the month in both America and Britain, the revival of the Japanese economy after decades of deflation, and the stabilisation of the eurozone in the wake of a crisis that threatened its very existence. Financial markets have gone from strength to strength with equities near record highs, even after the financial markets felt the ripple of turmoil in the more prone emerging markets. Strong central bank leadership and a controlled use of loose monetary policy has underpinned this global economic recovery and taken the US Federal Reserve to a new stage in its unprecedented monetary policy experiment: the phased and gradual retreat from quantitative easing (QE).

The Fed last week announced a further $10 billion cut to its monthly asset purchases as it looks to offer markets credible guidance and stability. Although there has been some short-term market volatility and central banks in emerging nations face a challenging start to the year, the US Central Bank will want to keep to the path set down by its former chairman Ben Bernanke (who presided over his last meeting in Washington last week). The continued improvement of the US economy has allowed the Fed to start to dismantle the support structure of quantitative easing. With economic recovery underway and inflation controlled, the US is leading the way to the next phase in this strategy of ultra-loose monetary policy: a normalisation of interest rates.

The Fed's hint in May last year that it would roll back QE and the subsequent start of the taper have created problems for emerging nations, from the exodus of foreign money to the sharp corrections in financial markets. The economies most seriously affected – including Brazil, India, Indonesia, Turkey and South Africa, or the 'fragile five' – are those that have built up large current account deficits since 2010. "Their recent lack of discipline means they now need a period of monetary and fiscal tightness before their economies regain momentum in late 2014 or 2015," warns Invesco Perpetual chief economist John Greenwood.

Keep calm

Last week's fresh round of difficulties prompted an exodus, mainly by retail investors, from emerging markets. EPFR Global reported that emerging market equity outflows rose to $6.3 billion last week – the biggest weekly withdrawal since August 2011 – with the total for the month hitting $12.2 billion. But, despite the nervousness over developments in emerging markets, talk of a re-run of the 1997–98 crisis seems overplayed. The International Monetary Fund says that most of the emerging markets are less vulnerable than in 1997, although they are exposed to the end of easy money. Panic can be self-fulfilling. A measured response from investors, as the Fed beats its orderly retreat from QE, is in the long-term interests of all.

Global equities sustained sharp losses amid these uncertainties. In New York, the S&P 500 index fell 0.7% on Friday to 1,783 points, losing 0.2% over the five-day period and 3.6% so far this year. In Europe, the FTSEurofirst 300 index lost 0.2% on Friday and 0.8% over the week to close at 1,291 points, which amounts to a 1.9% decline this year. UK equities were hit by the emerging market turmoil, as well as weak corporate results, with the FTSE 100 down 0.4% on Friday to 6,510 points. The UK index's highly international nature contributed to a 2.3% slump over the week; while a 3.5% decline over the month was its worse start to the year since 2009. In Tokyo, the Nikkei 225 Stock Average, with its exposure to Asia's developing economies, dropped 0.6% on Friday to 14,915 points, which is a 3.1% loss over the week and 8.5% in January.

Nervous investors last week gravitated towards assets deemed as safe havens, including government bonds, the dollar and the yen. The growing sense of risk aversion in the market translated into a strong week for fixed-income assets, with yields on government stocks pushed lower as investors sought shelter amid the global emerging market turmoil. The ten-year US Treasury yield was down 4 basis points (bps) on Friday at 2.65%, which is a drop of 9bps over the five-day period and 38bps for January. German ten-year bond yields were down to 1.66% on Friday, which is a 28bps drop since the start of the year.

World wobble

The backdrop for this fretful week for global equities was a sell-off of emerging market currencies, while central banks across exposed developing nations raised interest rates in an attempt to steady markets. The currency rout was triggered by Argentina's decision to devalue the peso the previous week and let it slide against the dollar by 15%. The move by Buenos Aires stirred memories of the 2002 crisis that engulfed Argentina, Brazil and Uruguay and heightened nerves among investors already jittery about the current account deficits and runaway public spending of a number of emerging market nations.

Turkey, South Africa and India raised interest rates to ease the pressure on their currencies and the risk of increased inflation. Turkey's central bank abandoned its policy of low interest rates to encourage growth with a move that more than doubled its key rate to 10%. South Africa raised its interest rate by 0.5% to 5.5% and India notched its up by 0.25% to 8%. Meanwhile, Russia intervened to support the rouble. Concern also mounted over speculative pressure on European emerging market currencies, including Hungary's forint.

Unease also circulated last week around the trajectory of the world's second-largest economy, China. Emerging markets hitched to the march of the Chinese economy, particularly commodity exporters such as Brazil and South Africa, face uncertainty over the rate at which growth is losing momentum. Worryingly, data indicated last week that output from China's factories contracted for the first time in six months. A slowing of the Chinese economy will weigh on investment sentiments, together with concerns over the expansion of credit to an estimated $15 trillion in China since 2009, to fuel the country's property and infrastructure boom.

Stimulating debate

Amid these challenges in the emerging markets, there are some who believe ultra-loose monetary policy has stored up dangers for both developed and developing economies. For example, emerging market specialist Jonathan Asante at fund manager First State believes QE is not a cure for the global economy. "We have never believed that QE would solve the world's problems and ultimately see tapering and the end of QE as a positive," says Asante. He fears that the global financial system is far from sufficiently reformed to provide a strong enough check on speculative activity. "Notably the risks for inflation (of all types) eroding even further the purchasing power of increasing sections of society imply headwinds for many companies," he adds.

A criticism of QE is that it has distorted markets with easy money for the benefit of wealthy individuals or nations and, as the turmoil across emerging markets demonstrates, that its withdrawal will further benefit these groups. As we have argued, QE is neither a panacea nor a risk-free solution, but has offered central bankers a mechanism with which to create the conditions that advanced economies need to gain confidence and move clear of the 2007–08 financial crisis. The recovery is underway, helped by ultra-loose monetary policy, and the return to prosperity will benefit the world's economy. "A stronger global economy is good for emerging markets too," adds Julian Thompson, head of emerging markets at fund manager AXA Framlington.

Undoubtedly, parts of the world are reacting adversely to the Fed's reduction of stimulus. Capital has flowed back from emerging market currencies as the US economy recovers. "Ordinarily, this would not be too much of a problem," explains Thompson. "However, it is happening just when growth has slowed in emerging markets." But he believes that the majority of emerging market central banks have taken pre-emptive action, and the problem they face is cyclical rather than structural (although he warns against expecting a return soon to recent levels of growth). And, for investors, the silver lining is that many growth companies are now available on attractive valuations.

Bonds back

The volatility in emerging markets has also spurred a switch out of equities into bonds. Institutional investors, on the back of big equity gains in 2013, have been looking to ballast their portfolios with attractively priced bonds. Although equities are widely considered to have further to go amid the recovery for the developed economies and stronger corporate earnings, upward pressure on bond yields, which have an inverse relationship with prices, have made government debt fairly valued.

However, research by Invesco Perpetual estimates that cash and government and corporate bonds in the US, the UK and the eurozone produced an annual income of $550 billion, down from $1.4 trillion at the end of 2007. "Nearly $900 billion has gone," says Invesco's fixed-income specialist Paul Read. "Investors looking for real returns have no choice but to take some risk, and the market has become more risk tolerant." With income falling from risk-free sources, flows have increased to riskier fixed-income areas. Around €600 billion has been moved into bond funds in Europe since early 2010, according to analysts Lipper.

Read observes that markets have had time to readjust to higher yields. Consequently, longer-dated core government bond values this year could start to look relatively attractive. While short-term bond yields are dictated by interest rates in place to stimulate growth; longer yields reflect market expectations for growth, inflation and the economic recovery. "This is a traditional reaction to greater market confidence," he adds. "The next step could be that the market starts to question whether shorter-dated yields should be so low."

Brother's keeper?

As American central bank policy rippled across world markets, Scotland and its diaspora recovered from the late January patriotic revelry of Burns Night – and the Sassenachs' Canadian central bank chief rolled into Edinburgh to give a sobering speech on currency union in the event of Scottish independence. Mark Carney stressed his technocratic impartiality and warned that for an independent Scotland to share the pound it would need to accept "some ceding of national sovereignty". On these loftier matters of state and finance the Better Together campaign looks to have the high ground; with surveys, incidentally, showing that the more wealth and stake in the prosperity of Scotland its voters have, the less inclined they are to support independence.

The Bank of England governor's non-partisan assessment of the limits of an independent Scotland's fiscal autonomy is a voice of clarity. Despite a breezy confidence among secessionists in the shared pound, currency union would hold out little hope for autonomy on tax and spending matters. As well as curbing national sovereignty, a joint currency would require shared mechanisms to counter financial risks and more not less financial integration. And that is why the UK government holds that, in the event of independence, a currency union is highly unlikely and the Scottish government needs a Plan B. Meanwhile, as Carney pointed out, deep integration exists between Scotland and the rest of the United Kingdom, which buys 70% of Scottish "exports".

Invesco Perpetual's Greenwood, who as an economic adviser in the early 1980s helped steer Hong Kong's link to the US dollar, points out that nationalists used to favour the euro, until the eurozone crisis exposed the flaws in its monetary institutions. Furthermore, he observes that monetary union, paradoxically, between an independent Scotland and the UK is only workable with institutions that nationalists would abhor. And a Hong Kong-style currency link would require an Edinburgh authority so yoked by constraints, in part to guard a Scottish pound against speculative attack, it would make a mockery of independence. Investors have been sanguine about the vote in September. Some sound Scottish rationalism is now needed to weigh up the emerging details of this alternative to the Union.

AXA Framlington, First State and Invesco Perpetual are fund managers for St. James's Place Wealth Management.

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