Citigold

Eye on the Market.
Bringing you expert views.

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Fear of Illiquidity

Fear is back in the markets and risk markets, especially EM currencies, have been heavily sold off. Amid this market sell-off, we have received many questions on whether we are still staying the course on our 2014 core views and market themes. The answer is yes and there are good reasons why.

Citi analysts see little justification for the recent sell-off. Most of the triggers for the current pullback are nothing new and our base cases and assumptions remain intact. Looking at the big picture, the EM currency crisis is about liquidity withdrawal by the Fed. QE boosted EM currencies against the US dollar, so the rewinding may be painful. Given US Treasuries went sideways for four months so far, this does not seem to be the trigger for the current sell-off, but it is the underlying reason.

What are the issues now?

So what triggered this risk off mode? The first trigger was slowing growth and credit concerns about China. Last week China's weaker Flash Manufacturing PMI disappointed investors who already have little patience about the market. The Index fell to 49.6 in January, from 50.5 in December, which is below the consensus expectation of 50.3. This was the first reading below 50 in six months and a reading below 50 means a contraction in output. Is China's slowing growth risk something new that investors did not imagine? The number looks concerning per se, but Citi strategists have highlighted the downside risk to their 2014 GDP forecast of 7.3% for 2014, unless the pending urbanization plan is able to lift domestic demand effectively.

Moreover, signs that the first large wealth management product might default have been increasing fears about a financial banking crisis in China. However, Citi strategists see the recent PBOC's liquidity injection into the system as a first signal of the Government of China's re-focus on growth to maintain healthy expectations and employment. Citi believes that a financial crisis is unlikely although funding conditions are likely to remain structurally tighter. Against this backdrop, Citi strategists see an attractive risk-return profile in China as the recent developments sent China's valuations deeper into crisis levels.

The second trigger was Argentina's currency devaluation last week, followed by sharp falls in EM currencies. Citi economists think that this is unlikely to lead to contagion and the impact of Latin America's currency crisis would have little direct impact on global markets. There have been three major Latin American currency crises since the 1990s: the Mexican currency crisis from late-1994 to early-1995; the Brazil currency crisis of 1999; and the Argentina crisis from late-2001 to early-2002. None of these had a major impact on the direction of global markets. So far performances of Asia currencies held relatively well.

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Investment Implications

Overall the current developments may continue to negatively impact EM currencies and then EM debts. However, despite turmoil over the short-term, equity markets may see more upside over the medium-term, with the global economy and earnings transitioning into a 'growth' phase of the cycle. If the risk-off mode eases back, the current situation may present opportunities for those who see the big picture, ignore the market noise and scale in risk assets where there may be positive catalysts, such as an upward risk to economic growth or earnings growth.

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