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MARKET INSIGHTS

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What is behind this week's volatility?

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Investors are nervous

The root cause of the current market sell off is the continued deleveraging of governments, households and banks that began with the credit crunch. This has escalated due to fears that US/global growth is stalling.

This is why, for example, we have had weak employment growth data in the US (because states and households are cutting back on spending to repay debt). It is also why many European banks are unable to boost lending to support the recovery (because they over-lent to construction and property-related sectors in the previous decade).

Paying off debt, whether by the government, households or banks, reduces demand and so weakens economic growth. This increases the burden of any debt, so prompting further deleveraging. Some fear we are in a vicious circle that may lead to another global recession.

This week's market falls reflect a greater recognition of the deleveraging problem following the ending of QE2 in June and the renewed sovereign debt issues in the eurozone and the US, which have been accentuated by thin August trading.

How will the two big debt problems be resolved?

The eurozone debt crisis is likely to go on and on until there is decisive action by European governments. A solution to the crisis lies in the hands of policy makers, but as yet a sufficient consensus for decisive action has not been formed. A break up of the euro is not our base case scenario. The political commitment to the euro remains substantial and thus there are likely to be considerable efforts to sustain monetary union. President Sarkozy of France has already described the extension of powers given to the European Financial Stability Facility two weeks ago as 'the beginning of a European Monetary Fund'.

Meanwhile, the US debt crisis may reopen in November and December as the details of spending cuts are negotiated and as the Bush-era tax cuts once again come up for renewal. However, the crisis may have, perhaps ironically, actually helped Treasuries as it shows a determination to limit the deficit and the supply of Treasuries through fiscal adjustment, which is deflationary.

The trigger for a turnaround in market confidence may be an announcement of QE3. However there are valid doubts about the ability of central banks to combat the deleveraging mentioned above, without which any market bounce from further monetary stimuli will be temporary.

We shouldn't forget that many emerging markets are still growing at a strong pace. Although the emerging world will be affected by the slower-than-expected growth in the developed markets, longer term they probably represent the way out of this.

Asset allocation ideas

We would not recommend a flight to recent popular 'safe havens' such as the Swiss Franc or the Yen as these appear overbought and – as we have seen this week – they are vulnerable to central bank intervention. Meanwhile the US dollar and sterling appear undervalued.

Rather, for asset allocation look to the areas that we know offer long-term opportunities (emerging market debt and equities). For income, high yielding blue chips in the developed markets look more attractive than government bonds or cash.

For both strategies we would suggest dripping money in over say, a 12 month period, where possible. Timing an exact entry point is almost impossible in such volatile conditions.

Tom Elliott, *vice president*, is a global strategist within the Investment Marketing Team at J.P. Morgan Asset Management. An employee since 1995, he worked in the Global Multi-Asset Group (GMAG) until 2006 and before that he was head of the Investment Writing Team. Previously, he worked at Euromoney Publications as a feature writer for a year and prior to that he spent four years at Greig Middleton & Co. as a graduate trainee and securities analyst. Tom obtained a BA in History from Sussex University and an MSc in Economic History from the London School of Economics.

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