Wealth Management Systems Inc.

Tumult in Emerging Markets: A Catalyst for Renewed Volatility

The euphoria that lifted stock investors at the close of 2013 has given way to jitters as turmoil in emerging markets coupled with the Federal Reserve's pullback in stimulus spending have set major global equity indexes back on their heels.

Many analysts view the emerging markets situation as an indication that 2014 will be a year in which investors should expect slower market advances punctuated by heightened volatility.

The Dow Jones Industrial Average and the S&P 500 have declined 5% and 4%, respectively, year-to-date, amid a marked uptick in volatility, while European stocks have also dipped to their lowest point since mid-December 2013.[1,2,3]

Emerging Markets Threat

The current trouble in emerging markets started in those countries that rely heavily on foreign cash to finance their economies, such as Turkey and South Africa. The U.S. Federal Reserve's announcement that it would reduce monetary stimulus signaled a pullback on the amount of money available to fund emerging market countries. The result has been a chain reaction that has caused local currencies in many countries to plummet as nervous investors seek safer havens for their investment dollars.

Investor sentiment toward emerging markets had begun to deteriorate late last year after the Fed announced it would begin scaling back stimulus and China's economic growth began showing signs of slowing. As of February 3, 2014, the MSCI Emerging Markets Index had slipped 11% from its October 2013 peak -- and thus far in 2014, the index has suffered its worst start to a new year since 2008.[4]

By most accounts, however, emerging markets woes will have a short-lived impact on global stock performance. Few liken the current scenario to the "Asian contagion" of the late 1990s in which a currency crisis in Thailand set off widespread stock market declines in developing countries.

Rather, many analysts view the emerging markets situation as an indication that 2014 will be a year in which investors should expect slower market advances punctuated by heightened volatility. In January alone, the S&P 500 averaged daily stock price swings of plus or minus 0.6% -- an 11% increase over its average daily move in 2013.[1]

S&P Capital IQ's Global Equity Strategist, Alec Young, views 2014 as a year in which the S&P 500 will advance only 5% from year-end 2013 levels.[2] He cites factors that may cause investors to re-evaluate their portfolios with an eye toward mitigating risk. Chief among them, the concern that emerging market growth forecasts may have been overstated going into 2014 -- a concern that may be magnified this year as the Fed's tighter credit policy slows the flow of much-needed cash to these struggling economies.[2]

On the upside however, Young reminds investors that "U.S. exports to emerging markets remain very modest as a share of GDP, and that these economies are still likely to grow at least twice as fast as developed economies in 2014."[2]

Here at home, the Fed's steps to pare back stimulus spending will likely mean a wholesale rethinking of investment strategies as the government safety net that has buoyed stocks, breathed new life into the U.S. economy, and kept interest rates at near zero is slowly dismantled.

Takeaways for Investors

Given the more cautious outlook many investment analysts are recommending for 2014, consider discussing the following portfolio strategies with your financial advisor:

- For a stock portfolio, consider shifting away from investments that did exceptionally well in 2013 and that may be vulnerable to volatility in 2014. For example, this may include paring back on your exposure to small-cap stocks in favor of large company, dividend-paying shares that may be poised to benefit from continued improvement in the U.S. economy.

- For a fixed-income portfolio, consider shifting away from bond investments that are more vulnerable to rising interest rates toward short-term issues.

- Finally, for a sector strategy, analysts at S&P Capital IQ favor the Consumer Discretionary and Industrials sectors given their view that U.S. and international growth will accelerate in 2014; the Financials sector due to their expectations for a steeper yield curve and improving credit quality; and the Health Care sector as a more counter-cyclical play.[2]

[1] *The Wall Street Journal*, "Stock Investors Brace for a Bumpy Ride," February 2, 2014.

[2] S&P Capital IQ, Global Equity Research, "Down But Not Out," January 30, 2014.

[3] Reuters, "UPDATE 1-European shares lurch lower on emerging market jitters," February 3, 2014.

[4] Financial Standard Online, "Emerging market turmoil is a buying opportunity," February 3, 2014.