

# Flash Comment

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## Emerging Markets: Risk aversion shoots up

Risk aversion is rocketing today. The trigger may have been the near 9% sell-off in the Chinese stock market – its largest one-day decline in a decade.

However, a number of other factors may be contributing to the sell-off – especially the following:

- Increased geo-political risk due to the stand-off over Iran's nuclear programme
- Nervousness about overheating and large imbalances in Central and Eastern Europe (see "Research – New Europe: A warning not to be ignored", February 23, 2007).
- Problems in the US sub-prime mortgage market

The rise in risk aversion is self-reinforcing at the moment, as the JPY and CHF, which are the traditional funding currencies, are strengthening significantly. This is clearly negative for high-beta Emerging Markets like Turkey.

Meanwhile, concerns about the nuclear row with Iran are continuing to push oil prices higher – something which is obviously negative for Emerging Market oil importers with large current account deficits, such as the EMEA markets – from the Baltic countries, Central and Eastern Europe, and Turkey to South Africa.

Increased risk aversion generally hits Emerging Markets quite broadly, but we would be especially concerned about the high-beta markets that normally respond quite negatively to increased aversion, and the Central and Eastern European Markets. Last week's mini-crisis in Latvia was a clear reminder of the large imbalances in many CEE economies, and a further rise in risk aversion will undoubtedly accelerate market worries about these countries.

Concluding, the riskiest markets – equity, fixed income and FX – are the usual suspects, in other words, the high-beta/carry markets of: Turkey, Brazil, South Africa, Indonesia and Mexico and CEE. Risk in the CEE area is clearly greatest in the Baltics, Romania, Bulgaria and Slovakia – due to unbalanced growth.

Despite the sell-off, levels remain quite strong and in some cases quite overvalued/excessive in a lot of Emerging Markets, so one should certainly not rule out this sell-off continuing.

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