

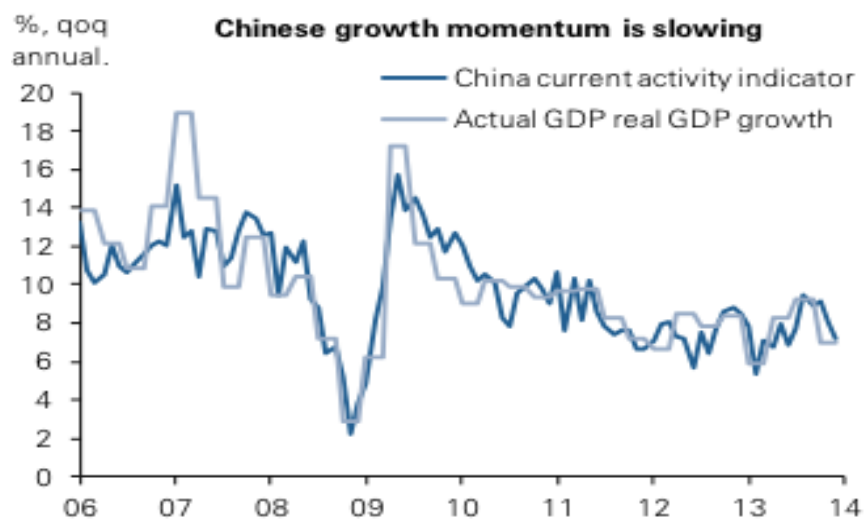
Market Insight: Emerging Market Turmoil

Emerging Market Turmoil Send Tremors Across Global Equities

It has been a bumpy start in 2014 for global stocks. The confluence of emerging country turmoil with the onset of Fed tapering suddenly created enough uncertainty for investors to question the sustainability of growth and future earnings, sending stock prices around the globe in rapid retreat. Not surprising the emerging countries have been hit the hardest with market declines of over -9% in Latin America, India, and China, with the latter spilling over into Japan -8.5%. At the same time, Europe declined -2.9% and the US S&P dropped -3.4% making it the worst January since 2010. Is this the start of a major decline, or is it merely a long over due correction?

To assess the current market environment it is helpful to understand what is happening in the Emerging Market (EM) economies and the relationship of the EMs to the Developed Market (DM) economies.

Emerging Markets (EM) Countries: EM economies are tightly interconnected and constitute about 40-45% of the world GDP, with China being the primary contributor. Over the last month, a 'triple whammy' has hit the EMs: Recent data from China indicates slowing growth; commodity prices are falling (EMs are major exporters of commodities); Federal Reserve is reducing its stimulus program, which is pushing US rates higher. These macro forces are major headwinds for the EMs because they have the effect of tightening financial conditions by putting upward pressure on rates, and downward pressure on the local currency of each country. The fear is that if China's growth continues to slow, it will trigger more currency selling, snowballing into a major currency crisis and slowing global growth. (The chart below shows China's growth momentum (rate of change) has leveled off since mid 2011.)

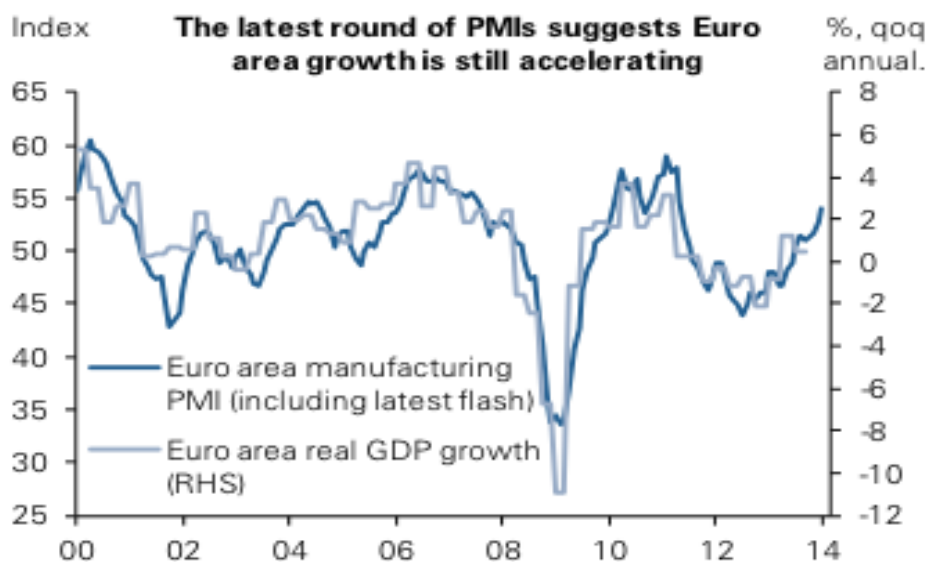


Developed Market (DM) Countries: Offsetting the negative forces affecting EMs is accelerating growth in the DM countries, in particular the US, Europe and Japan.

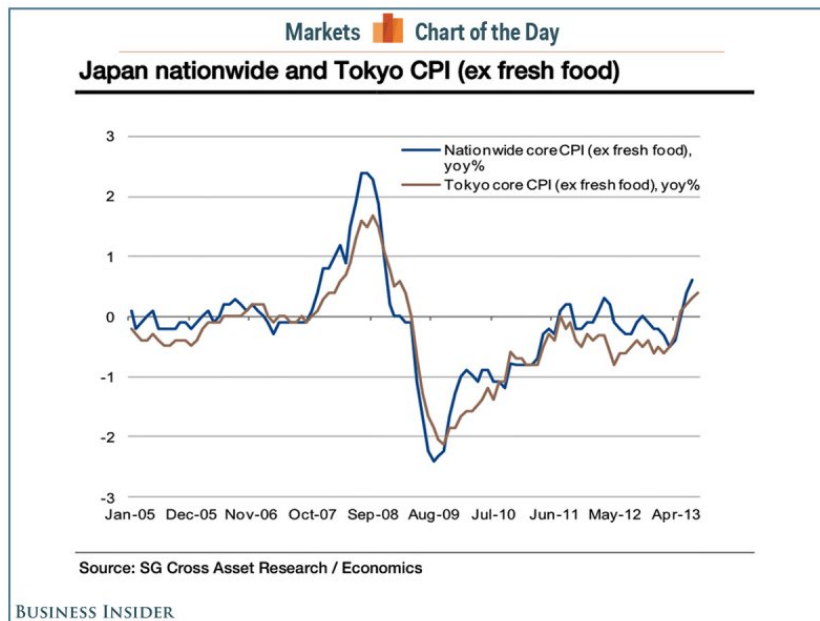
The **US economy is gaining traction and structurally healthier** than at any time over the last six years. Consumer debt is significantly lower, home prices are rising, productivity continues to increase, and corporations are deploying their abundant cash reserves for capital expansion. At the same time the "fiscal drag" from reduced government spending is subsiding. This had subtracted as much as 2.4% from US GDP growth in 2013. Now, 2014 GDP growth is expected be +3.0% this year, with the potential risk to the upside. Clearly the Federal Reserve has confidence in accelerating growth or they would not be reducing their bond-buying program. (The chart below shows US GDP growth and activity level gradually tracking higher.)



Meanwhile, **Europe has finally emerged from recession** and now for the first time since 2011, is actually contributing to global growth. (The chart below shows the acceleration of Euro area Manufacturing activity (left scale) and GDP growth (right scale) since late 2012.)



In Japan, the economic data is positive, showing an improving labor market and a welcome rise in prices. Deflation had plagued Japan for 15yrs, but recently prices are rising, an indication that growth is accelerating. (Below is chart showing acceleration of Japan's Consumer Price Index)



Balancing declining EM growth with accelerating DM growth.

The key question today is to what extent can accelerating DM growth filter through to EM economies such that the present headwinds will not slow global growth? It is a complex situation with many moving parts but I believe ultimately global growth will continue to accelerate. However, until more clarity is apparent, investors will remain skittish and the market will likely struggle to find its footing. This means higher volatility and potentially further downside in the near term.

Investment Strategy: Portfolios are structured such that they have been well insulated from much of the downside, because exposure to EMs is minimal and stock concentration remains mostly in the US and Europe. At the same time, the portfolios are generating income form High Yield bonds and floating rate notes, both of which are performing well.

Please contact me with any questions or concerns.

Kind Regards

Barbara

Barbara HS Huff

CEO & President

New Albany Investment Management

614-216-6139 ~ www.newalbanyinvestment.com

