Global equity markets have gone from complacency to near-panic this month. Even the once-impregnable U.S. stock market showed cracks. The correction and spike in volatility was long overdue, in our view. Markets are trying to find a new equilibrium – one that is less dependent on the ultra-loose monetary conditions engineered by central banks.

We see no single catalyst for the selling but a mix of interrelated factors: the slowing Chinese economy, commodities rout, and collapse in global growth and inflation expectations. Angst about the possible first rate rise by the U.S. Federal Reserve (Fed) since 2006 has added to the jitters.

China has been at the epicenter of events. It is rebalancing the economy toward services and consumption while trying to keep up growth previously fueled by credit and investment. Policymakers are walking a tightrope to introduce market reforms, as seen in the yuan devaluation and stock swoon. Their toolbox contains room for more fiscal stimulus, and cuts in interest rates and bank reserve requirements.

China’s slowdown poses challenges to global growth, particularly to emerging markets (EMs). Yet a global recession appears unlikely: The U.S. economy looks solid and eurozone data point to an uptick in growth there. Lower oil prices have pushed down inflation expectations but are a positive for the developed world in the long run.

U.S. employment has been strong, resulting in signs of wage pressures. The Fed, however, may have missed the opportunity to end its zero-interest-rate policy this year due to the collapse in inflation expectations. Timing aside, we see the Fed tightening at a gentle pace after "lift off."

The sell-off does not look like the end of the equity bull market, we think. It has restored some value and thrown up opportunities. We like European and Japanese stocks due to modest valuations, growth nudging up and quantitative easing. U.S. equities have started to look more reasonable.

A downturn in credit preceded the equity correction, and has made the asset class more attractive. Investment grade spreads have widened on bumper supply. High yield bonds actually carry high yields again, which is attractive in an income-hungry world. Default expectations are still low.

EM assets have both low valuations and low expectations. We prefer countries that are enacting reforms to open up their economies. We are wary of nations with high current account deficits or companies that have a currency mismatch in their revenues and debt payments.
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