Markets braced for the worst

By Ambrose Evans-Pritchard (Filed: 15/05/2006)

Global markets are bracing for turmoil today after an ominous slide in the US dollar and a slump in equity and bond prices late last week sent tremors through the global financial system, evoking memories of the 1987 crash.

Emerging economies have led the sell-off as investors recoil from risky assets, pummelling stocks and bonds in Turkey, Hungary, Iceland and much of Latin America.

The currencies of Brazil, Mexico and South Africa all suffered their sharpest falls in two years as foreign funds rushed for the exits.

In New York, the Dow Jones industrial index fell 262 points over Thursday and Friday to 11381, setting off contagion in Japan and Europe. The FTSE 100 had its worst drop in three years on Friday, falling 129.9 points, or 2.2pc, to 5912.1.

Analysts said there were now clear signs that monetary tightening by the world's central banks was starting to crimp growth. Lombard Street Research warned the US was now heading into outright recession, with China also facing a hard landing.

"Stock markets in the middle of 2006 are confronting a tight Federal Reserve and European Central Bank, sharply higher bond yields, and a downswing in potential profits," it said.

It raised the risk of "an impending financial crisis" caused by excess credit and leverage across the global economy. The group advised investors to liquidate stocks and move into cash yen until the storm has blown over.

The dollar has slumped 6pc against the euro and 8pc against the yen this year as the markets anticipate an end to interest-rate rises by the US Federal Reserve, switching attention back to America's debt mountain and current account deficit of 7pc of GDP.

Volkmar Hable, chairman of Samarium Technology, said the world was now on the brink of a dollar crisis.

"The crash in the autumn of 1987 started with a massive dollar and bond decline in the spring. We are experiencing exactly the same now," he said.

Ominously, bonds are no longer viewed as a safe haven, a sign of fear that inflation is gaining a foothold in the major economies.

Interest rates on 10-year Treasury bonds have jumped from 4.36pc to 5.19pc since February, in part because Asian investors are demanding a higher premium for holding risky dollar investments. The 10-year bond is the benchmark for economic activity in the US, setting corporate borrowing rates and the cost of most mortgages.

The bond slide is exacting a toll on the US property market, where the price of new homes has fallen for five consecutive months. A half-year inventory of unsold houses now hangs over the market.

Goldman Sachs, however, is sticking to its optimistic forecast, banking on a seamless "hand-over" from a slowing US economy to a re-awakening Europe and Japan, while China will continue to be an engine of global growth. The IMF is also bullish, forecasting roaring growth of 4.9pc in 2006, one of the highest rates in half a century.