Global Tumult Grips Markets

Question for Investors: Bumpy Return to Normal or New Volatility as Central Banks Step Back?

By DAVID WESSEL

The tectonic plates of the world economy are shifting, moving the yield on the 10-year Treasury to the highest level in more than a year and shaking financial markets from Tokyo to Mumbai and Johannesburg to São Paulo.

For the past few years, the global economy, struggling to recover from a financial crisis, has relied on a few constants: The U.S. would print plenty of money and keep interest rates very low. China would provide a lot of demand and vacuum up commodities from around the world. And Japan was largely irrelevant.

Suddenly, all three of those are being questioned in markets, triggering paroxysms in stocks, bonds, commodities and—particularly, in the past couple days—the currencies of emerging markets.

The big questions hanging over markets and the global economy now:

Is this the inevitably bumpy beginning of a welcome return to normal—a world in which the U.S. economy doesn’t need big and repeated doses of monetary stimulus, Japan grows again and China’s economy gently slows to a sustainable speed?

Or is it a harbinger of more volatility in financial markets—perhaps the result of a misreading of the Federal Reserve’s policy intentions by the markets or a premature move by the Fed to cut back on easy money—that yields an unwelcome increase in market interest rates before the U.S. economy achieves what Fed Chairman Ben Bernanke once called “escape velocity”?

Answering those questions now is impossible.

“There are spillover effects of the monetary policies that we’re seeing in the world right now,” Jim Young Kim, president of the World Bank, said in an interview in Montreal. “One of the concerns is what’s going to happen if there’s a sudden stop to the loose monetary policy? What’s going to happen to access to capital [for] developing countries?”

For now, the uncertainty is producing a lot of volatility.

Leading the way: The yield on 10-year U.S. Treasurys, acutely sensitive to market perceptions about the Fed’s policy direction, hit a 14-month high of 2.27% in trading Tuesday before easing a bit; it’s still low by historic standards but substantially higher than at the beginning of May.

In 10 of the 30 trading days since the Fed’s last policy meeting on May 1, the Dow Jones Industrial Average has moved more than 100 points. On five days, it was up; on five, it was down. In trading Tuesday after other global stock markets slid amid growth and monetary-policy concerns, the Dow opened with a triple-digit drop, erased those losses by lunchtime, and then weakened again. The Dow ended down 116.57 points, or 0.76%, at 15122.02.

The prospects for slower growth in China, meanwhile, are pulling commodity prices down. Since the start of the...
year, the price of copper has fallen 12% and the price of Brent crude, a benchmark price for oil, has dropped more than 7%.

Japan’s stock and bond markets have been riding a roller coaster as attitudes shift almost daily about the new government’s economic program and the Bank of Japan’s big bond-buying effort. After the central bank refrained from announcing any new steps Tuesday, Japan’s Nikkei Stock Average fell 1.5%; on Monday, it had risen 5%. Early Wednesday, Japanese stocks fell about 2%. Last week, the Nikkei was up 2% on one day and down nearly 4% the next.

The upheaval has spread beyond major markets. The combination of relatively more-attractive interest rates in the U.S., threats to emerging-market exports and the prospect of further volatility contributed to sharp declines this week in currencies of emerging markets.

That prompted a round of intervention in currency markets by several governments which, just a few months ago, were worrying that their currencies were uncomfortably strong.

India’s central bank moved Tuesday to stop the slide in the rupee; it’s down 7% against the dollar since the beginning of May. Poland’s central bank has done the same to prop up the sinking zloty. South Africa’s rand fell 1.1% against the dollar Tuesday and is now down 16% since the start of the year. And Brazil’s government—which was fretting about a nearly 10% run-up in the real against the U.S. dollar from the end of November to early March—is now worrying about a decline of nearly 9% since then.

About the only major slice of the world economy for which the story hasn't changed lately is Europe. It is still mired in recession; the euro-zone economy has contracted for six quarters in a row and forecasters don’t expect growth in the current quarter. European governments are largely paralyzed by disagreements over how best—and, in some quarters, whether—to pursue further integration of the national economies that share the euro. The European Central Bank said last week that it "continues to see downside risks surrounding the economic outlook for the euro area" but didn’t take any additional steps in response.

Economists at J.P. Morgan Chase have turned mildly hopeful lately that the U.S., Europe and much of the rest of world economy will shift into a higher gear later this year, in what would be a pleasant contrast to the midyear slumps seen in recent years.

Although governments in the U.S. and Europe are tightening their belts, the bank’s economists see that offset by buoyant stock markets, accelerating consumer spending in much of the world, an improving U.S. job market and lean manufacturing inventories.

The International Monetary Fund is more cautious. "Recent data suggest some slowdown in growth," Managing Director Christine Lagarde said in a speech last week, pointing to weakness in China and dim investment prospects in Brazil, India, Russia and South Africa. "We could be entering a softer patch."

Given the uncertain global growth picture, the markets and forecasters are fixated even more than usual on the Fed and whether it intends to scale back its $85-billion-a-month in bond buying later this year, as some officials have suggested. The yield on two-year Treasurys—a barometer of market expectations for Fed short-term rates—has been inching up lately

"Part of this is the normal volatility you know you're going to get as you approach the date at which policy accommodation is going to be pulled back," says David Stockton, a former top Fed staffer now at the Peterson Institute for International Economics, a Washington think tank.

Some of it may be a misreading of the Fed, which, he said, "has not been as clear about its intentions lately as it has been over the past couple of years." If so, Mr. Bernanke may try to clarify Fed thinking at a news conference scheduled for June 19 after a scheduled policy meeting.

The Fed’s current strategy relies on convincing the markets that while it may reduce the size of its bond-buying in the next several months, it still intends to keep short-term interest rates very low until unemployment, last measured at 7.6%, gets to 6.5%. 
But, Mr. Stockton added, "Some of this may be legitimate concern that" the Fed is preparing to pull back on its bond-buying even though "the global economy is still not looking like it's in takeoff mode."

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