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High uncertainty, low volatility

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Uncertainty is high, while volatility is low. How to resolve the contradiction?

Uncertainties

The uncertainties are related to the high level of global debt, low productivity growth, extremely expansive central bank policies, the divisive forces in the EU, the surge in political populism and the uncertain answer to the question of which macro-economic state the global economy is currently in or will be in in the future (lowflation, deflation or inflation).

The future is uncertain, that's for sure. Particularly in times when many developments are new compared to the recent past: the Great Recession has been a turning point. But when we look at more recent trends, the picture we get is a bit more optimistic.

Global growth favourable

In its new World Economic Outlook, the International Monetary Fund projects the global economy to grow by 3.1% in 2016, following 3.2% growth in 2015. The forecast was not revised down compared with the July estimate, which is a fact that can be considered positive in itself.

Industrialised nations disappoint

Admittedly, the 2016 growth forecast for advanced economies has been marked down compared with the July estimate (by 0.2 percentage points to 1.6%); last year's growth was still 2.1%. However, highly significant indicators such as industrial production and survey indicators are at least pointing to growth stabilising at this level, which corresponds to the reduced potential growth.

Emerging markets doing surprisingly well

In contrast to the industrialised nations, growth in emerging markets and developing economies is expected to pick up in 2016 (by one tenth of a percentage point to 4.2%), which marks an increase of 0.2% compared with 2015.

The difference in growth between the industrialised nations and the emerging markets is therefore expanding, with the dynamics taking place in the emerging markets. Russia and Brazil are recovering from recession, and commodity prices and currencies have stabilised. Economic policy in China is enabling the gradual slowdown of its growth rates and a rebalancing of

its economy as a whole, while admirable structural reforms are being implemented in India, with the economy showing robust growth.

Favouring emerging markets
This development is reflected in Asset Allocation. Firstly, we favour government bonds in emerging markets both in local and hard currencies. Secondly, we overweigh emerging markets in country equity allocation.

To summarise, three risks can be deduced from the dichotomy between high uncertainty and low volatility.

TINA
The global economy is growing remarkably evenly, i.e. with low volatility. Relatively small confidence shocks, such as that experienced after the Brexit referendum or that was triggered by the depreciation of the Chinese currency, can be overcome by expansive central bank policies. The related uncertainties have relatively little impact on direct growth. However, market prices do not reflect these uncertainties. The TINA (There Is No Alternative) approach is dominating. As long as the risks do not turn into realities, risky securities classes continue to be purchased since secure government bonds only promise very low yields.

The liquidity trap
The cycle of crisis – central bank intervention – stabilisation and/or improvement – disregarding of risks – new crisis could be broken since central bank policies are becoming ineffective or even counterproductive. The Bank of Japan is one example. It is highly committed to overcoming the deflationary trend, but its measures taken last September (implicit promise to continue to lower real yields into negative territory) seem somewhat desperate.

Policy mistakes
Monetary and economic policy might be based on false macro-economic assumptions. When important global markets are in secular stagnation, it means that prolonged negative real yields are required to ensure growth. (More substantial) interest rate hikes in the USA or a reduction in the bond purchase programmes in the Eurozone could trigger a recession or lead to market turbulence. Furthermore, government aid for systemically important, failing banks could be granted too late. Additionally, protectionist action taken by a President Donald Trump might result in a trade war.

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