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## The return of volatility

Gerhard Winzer



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Earlier this year the president of the ECB said we would have to get used to elevated levels of volatility. And it is true, the market environment has changed. The years 2009 to 2014 were subject to an asset price reflation regime. High rates of return were coupled with low volatility. This relationship has now reversed. The asset classes are now pricing in the moderate recovery in the industrialised economies, with low expected return amid elevated fluctuation as a rule.

### Stabilisation

The financial markets have at least stabilised after the slump at the beginning of last week. The spreads for the default and liquidity risk on the money and capital market have fallen slightly, and the equity prices and the rate of inflation priced in have increased by a bit.

### Trigger

The two triggers of the most recent price declines, i.e. the devaluation of the Chinese currency relative to the US dollar, and the expectation of a rate hike in the USA this year, have calmed down. The Chinese central bank has reacted to the market turbulences by slightly strengthening the Chinese currency at the fixing vis-à-vis the US dollar. Also, the actual exchange rate is now not above the fixing anymore, but below it. In the USA the Fed has calmed the markets with cautious statements. The reasons for an increase in the Fed funds rate are not that convincing anymore, according to the central bank.

### Rate hike by the Fed still on the agenda

That being said, the Chinese currency might continue to depreciate in the coming months. Also, the US-specific reasons for a rate hike are still the same (improvement on the labour market, growth above potential, inflation target to be reached in the long term). In this context: the ECB also sent out dovish signals (annotation: signals that indicate anything but a tighter monetary policy) last week. The bond purchase programme might be adjusted in terms of volume, duration, and composition. The goals, i.e. a calmer market and another weakening of the euro, were achieved. However, for an actual realignment of the monetary policy, much more would have to happen first.

### Deteriorating environment in the emerging markets

What remains is the deterioration of the environment in the emerging markets: higher interest rates, falling exchange rates, high debt in the private sector, weak economic growth, low power of the companies to set prices, and falling commodity prices. Similar to an increase in the key-lending rate, the deterioration of the environment will only be feeding through with a time lag to the emerging economies.

### No correction in the industrialised countries

The economic indicators in the industrialised countries suggest the continuation of the moderate economic recovery. Both the USA and the Eurozone are on their path to recovery at growth rates of 2.1% and 1.4% (annualised), respectively, i.e. 0.4 percentage points above potential growth in both cases, in the first half of 2015 (Source: Bloomberg). Since the economic environment has not deteriorated in the industrialised economies, the slumps in the industrialised economies were no actual correction, but can be explained by a general reduction in risk.

### Core question

How strong are the spill-over effects from the emerging to the industrialised economies? Two main channels are relevant in this context: the emerging markets export deflationary pressure to the industrialised economies; and the emerging markets export a deterioration of the financial conditions to the industrialised economies. We will have to wait and see whether the economic outlook in the industrialised economies will actually deteriorate.

### Positioning

The environment implies a cautious stance vis-à-vis risky asset classes in the industrialised countries, generally high cash ratios, the protection against the risk of deflation with risk-free government bonds, and an abundantly low exposure to emerging markets.

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