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## Increasing volatility expected

Gerhard Winzer



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In the weeks following the Brexit referendum, the prices of many asset classes were rising amid mild fluctuations. However, an increasing number of clues suggest higher fluctuation for the coming months.

### **There is no alternative**

The very expansive monetary policies of the central banks are the most important reason for the price rises. The bond purchase programme and the negative interest rate policies in the Eurozone and Japan, the expansive measures in the UK, and the wait-and-see stance taken by the US Fed have caused government bond yields to fall to very low levels; as a result, the search for yield has become more intense. The investment approach is best summed up as TINA – “there is no alternative”. However, the impulse sent out by the falling government bond yields is starting to fade away, at least for now.

### **Fed funds rate hike in the USA**

The US central bank has signalled an increasing willingness to raise rates. The labour market is approaching the goal of full employment, and the inflation indicators suggest that a floor has been found. Also, the international economic risks (hard landing in China, Brexit) and the financial market have stabilised. The determining factor for the extent of the rate hike is the relation of the effective US dollar and the interest rate hike priced into the market. The more significantly the Fed policies de-couple from other central banks, the more the upward pressure on the US dollar will rise. This in turn will dampen the extent of the Fed interest rate increase. In a nutshell: we will likely see a raise of the Fed funds rate in December, which is not fully reflected by the market prices. But the expectations of a rate hike might already increase prior to the meeting of the FOMC in September.

### **ECB in wait-and-see mode**

In the Eurozone there is no convincing argument for a further downward revision of the inflation projections. This means the ECB will maintain its wait-and-see stance in September. The markets might react nervously to the absence of any signals suggesting an extension of the bond purchase programme.

### **Bank of Japan might disappoint**

We are faced with a similar situation in Japan. After Bank of Japan's chair Kuroda's announcement of a comprehensive evaluation of the monetary policies for September, expectations of further measures are high. Here, too, the market participants could be disappointed.

### **Constant growth**

At the same time, economic fluctuations are subdued. While indicators suggest below-average yet constant real economic growth of 2 to 2.5%, the economic risks remain elevated: productivity growth, company earnings, and capital expenditure in the corporate sector are down, while industrial production and foreign trade in goods are rising only marginally and lending growth in the emerging economies is on the decline.

### **Falling deflation pressure**

Indicators suggest rising wage inflation in the USA. If the rate of decline of the prices of goods continues to narrow, the base effect will cause higher inflation rates in the coming months.

### **Political uncertainty**

Also, the political uncertainty has not been fully factored into considerations. The anti-establishment movement remains a risk. The focus is on the US presidential elections and on the referendum on a possible constitutional amendment in Italy. The Brexit referendum was only seemingly a non-event for the markets and the economy. The effects will become apparent only in the long run. The political and geopolitical events will (probably) have a crucial influence on the markets. Two major trends are currently going through a reversal: globalisation and the integration of Europe.

### **Falling effectiveness of central bank policies**

The effectiveness of the central bank policies is falling. With every additional monetary measure one can ask the question whether aggregate demand can be stimulated by (still) lower costs of capital and (still) higher asset prices. The pressure on other areas of politics to contribute, e.g. with increased public spending on infrastructure, is rising. There is nothing to suggest that a

comprehensive, mutually adjusted approach is being pursued. This means among other things that the market participants are too relaxed about the ability of politics to solve problems in the event of crises or market slumps.

### Credit risk preferred

In our asset allocation we maintain the neutral weighting of equities. An increase would necessitate rising company earnings. We have reduced the portion of government bonds (USA, Eurozone) in favour of corporate bonds (USA, Eurozone) and have left the mix of government bonds (local and hard currency) in the emerging economies unchanged. The bull market for government is slowly coming to an end amid very low yields. Even though we expect higher volatility, the environment continues to call for the TINA approach.

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From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.