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THE STATE OF THE "GLOBAL" ECONOMY: Please note the inverted commas……

Summary	Investment Conclusions
Just like the "Holly Roman Empire" which was neither Holly nor Roman nor an Empire, the global economy is not global nor an economy in the sense that, its key G3 component parts, are in different cyclical, economic and policy phases. The recent convulsions in the markets are the result of investors acting haphazardly in the absence of "global" trends. What is riling, however, is the discovery by members of the Fed that a stronger USD is bad for the US and for the world despite the fact that the US is not an exports driven economy, and, it is its policies which are causing the USD to strengthen.	However repetitious this is, the equity markets which have consistently outperformed all others are those of the smaller Asian economies, while in the G3 group the US will continue to be the best performer. As for Fixed Income, the twists and turns of the Fed, now with the state of the global economy, and not that of domestic unemployment being of key concern, will keep volatility up in the longer end of the curve. We still look to the much maligned AUD, as it will remain the highest yielding currency in the G20 group providing both "sovereign safety" and high rate differentials.

The Global economy once more

The recent volatility in the global capital markets was triggered by the poor performance of the EU, the new measures of the ECB, the uncertainty over the next tax increase in Japan and, finally, the discovery by the Fed that a strong USD is not good for anyone, including the global economy and the US. Little wonder that equities sold off and UST yields fell as "safe havens" were sought. The likelihood that the Fed may delay hiking rates was not of great comfort to the markets. Chart 1 shows the sharp rise in the "VIX" indices for the US (green line) and the Eurostoxx (yellow), while the red line is the trade- weighted USD index which has started to rise since midsummer this year.

Consider now what is happening in the macro space of the G3 economies.

The **US** economy continues to do well on the employment side, except that now the impact of the poor global outlook is likely to be influencing the decisions of the Fed as to the timing of the next hike in rates is concerned. The **Japanese** economy is giving ambivalent signals. The steep decline in GDP growth in 2Q.14, reflecting the impact of the sales tax hike on spending, is expected to be reversed in 3Q.14.However industrial output growth is still shrinking and the recent Tankan report for small enterprises was poor,while exports and imports volumes growth continued to shrink.The debate is now as to whether the next sales tax hike should take place in 2015.The BoJ has done all it can while the USD/JPY has weakened since July. The Nikkei remains the worst performer in Asia showing the total absence of faith of investors in Abenomics.

Chart 1: VIX (green), VIXEurostoxx (yellow),USD trade weighted index (red), 2014

Source: Bloomberg

The ECB tries, again,what does not work

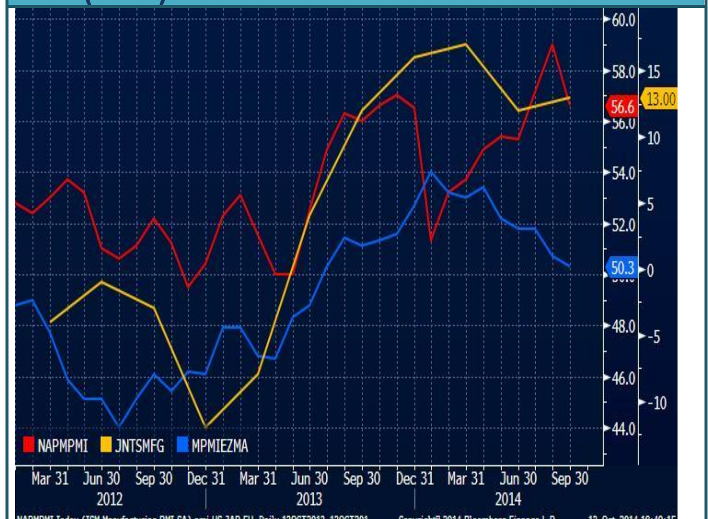
The next policy move from the ECB is to increase its balance sheet by over EUR 1.0 trillion to what it was in 2012.This will be done by buying Asset Backed Securities (ABS) from banks. By buying these securities the ECB replaces them with liquid and safer assets in the balance sheet of the banks, that is, deposits with the ECB.This will also bring corporate yields down, and the combined impact of higher liquidity for the banks and lower rates will cause bank lending to increase thus boosting the EU economies and, hopefully, accelerate inflation. There are several questions here to consider. Firstly, there are limited amount of ABS in the hands of the banks and, although estimates vary, there might not be enough on offer to create a significant liquidity impact and fall in yields. Secondly, the ECB will take on risky assets in its balance sheet Any default may

FACTBOX : Oh really ?

Statements by Fed officials that the stronger USD may harm the US economy are at best disingenuous and at worst ignorant of basic market dynamics. With the EU and Japan stuck for the duration at zero rates, how it could have possibly escaped the Fed that impending higher USD rates would strengthen the US dollar? But exports from the US are about 10% of the US's GDP and, hence, even substantial variations in the NET (exports-imports) balance, which is what matters for GDP growth, would have little impact on US growth. Worth repeating, the US is not an exports driven economy.

require recapitalization of the ECB, and we all know what the Germans will think of that! Thirdly, there is no explanation whatsoever how buying ABS will trigger more spending on shoes and milk in Greece, on haircuts in Portugal (the ones involving hair and not securities!) or how this could cause French industrialists to invest more on capital equipment. Despite the sarcasm of this rhetorical question, its essence remains. How will this policy cause more retail sales, let alone capital spending? The ECB has had low rates for years now and investment as well as consumer spending has not been responding, so why it should do so now? Lower rates is not the issue as the banks in the EU have shown repeatedly, especially with the cheap loans which the ECB

Chart 2:US ISM (red),Japan big Tankan (Yellow),EU PMI (blue) 2012-14



Source: Bloomberg

Same conclusions as before

had plied them with. Banks did not want to lend to shaky businesses and instead they parked their money either with the ECB (hence the recent negative interest rates rules to stop them from doing so) or bought safe EU government bonds.

Incidentally, switching the target from ABS to EU government bonds is simply a matter of asset choice and the impact on the markets should be the same. However, the ECB buying government bonds is legally tricky as the ECB cannot fund fiscal deficits and, hence, the bonds must be second hand, which is legally OK but may still meet with stiff resistance from Germany. The ECB may even extend these purchases to Greek and Portuguese government bonds which are much riskier than German bonds.

Conclusions? Avoid the equities of poor macro performers, such as the EU and Japan, stick to the US and to healthy, small, and bigger, Asians (India, Thailand, Indonesia and the Philippines) and be weary of longer term bonds. And, almost forgot, keep an eye on the AUD despite near universal pessimism on its future.

Andrew Freris (writing completed 13/10/2014)