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What and why it is going on? Will it stop and, if so, when?

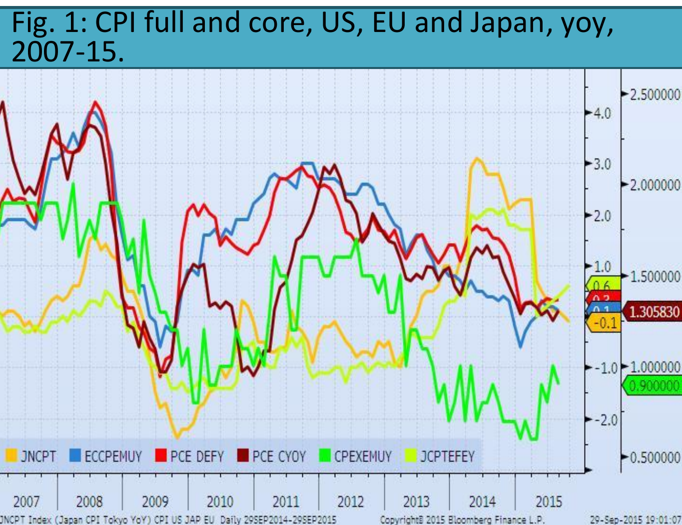
Summary	Investment Conclusions
The volatility of global markets, equities, forex etc, seem to be getting worse and less connected to any reasonable interpretation of facts and data. The Fed does not help with a near suicidal, and poorly explained, insistence of hiking rates, Abenomics is not working, deflation in the EU is not improving, commodity prices eep falling and a lot of investors convinced themselves that China is not only driving the global economy but its engine is about to fall off a cliff and drag the rest of us. And then VW chips in, thank you, and Spain is threatened with dismemberment. In the wise words of a friend of mine, "we are ALL going to die" Well, not quite.	The environment for equities stays poor while the Fed vacillates and China's economy is not bottoming. Hence stay overweight in cash till the end of 1Q.16.One can enumerate the Asians which did best (smallest YTD negatives that is!) such S.Korea and the Philippines and the SENSEX supported by the RBI. The Nikkei has done relatively well in USD terms helped by the strengthening JPY, the latter bad news for Abe. Bund yields could fall more supported by the ECB which could loosen up more. As we expect that the Fed will not hike till 1Q.16 or even later, the AUD might be worth a look.

What and Why

The current hysteric state of the markets reflects the combined impact of the following four factors. **One**, the fear of Fed hiking and the continuous uncertainty while the Fed tries to postpone. No one believes that it is all priced in the market, because if it was, there would be zero reactions to the "ifs and buts" of the Fed. The markets do not want higher rates, not now anyway. **Two,** the "global" economy is neither global nor an economy. The G3 monetary and fiscal policies are completely unsynchronized, with the BoJ and the ECB more than ever loosening, while the Fed threatens to tighten,with fiscal policies very tight in the EU, becoming looser in Japan and possibly neutral in the US, bar the elections. Anywhere else, most monetary policies are loosening (most recently Taiwan, India and, of course, China) while Chinese fiscal policies have loosened significantly. **Three,** commodity prices have fallen and will likely stay low but for different reasons. Oil because of a surge in supply, copper, iron ore etc because of a drop in demand from China,and soft commodities because of successive good crops.Falling commodity prices have pushed CPI inflation down (Fig. 1).

Four,a series of disconnected events scared the markets. The renewed Greek crisis from April till its resolution in September, then the Catalan vote which will help destabilise politically Spain, one of the poster recovery economies, and then VW blowing a multidimensional hole in Germany, the strongest EU economy.To all that, add the refuggee problem. But not all four factors are man-made or policy-related.

Fig. 1: CPI full and core, US, EU and Japan, yoy, 2007-15.



Source: Bloomberg

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Will it stop and when ?

The obvious answer is that it will stop, but far more importanly is when, otherwise. like a fire, it can burn itself out and the global economy along with it, thereby fulfilling the predicition of global catastrophy.Herein our expected sequence of events putting the fire out.**First,** the Fed does not hike till later on in 2016.This adds to uncertainty but keeps rates down!**Second,** the Chinese economy shows signs of bottoming in mid to late 1Q.16 propelled by all the monetary and fiscal boosts implemented in the previous 6-9 months.This puts a floor on the Chinese equity market but does not necessarily lead to its recovery.**Third,** with China stabilizing, iron ore, copper, nickel and coking coal stabilise and even start recovering.Possibly even oil has a respite.Not so for softs, the Chinese will not eat more because growth reaccelerates.**Fourth**,the ECB will have loosened further in early 2016.Greece will be doing marginally better thus taking it off the screens. **Fifth,** Abenomics Mark IV (or is it V or VI?) will be implemented latest 1Q.16 if not by Christmas 2015.It is unlikely that it will have any effect (no reform of the labor market, agriculture etc, no results) as monetarist policies do not work (and never did anyways…) but all good for morale and possibly the Nikkei. **Sixth,** the Fed hikes by Easter , by then hysteria have subsided but the hike does create a mini-panic. Remember the hike it is not, and will not be “priced in”. Markets will immediately worry as to the next hike. So give it all six months from now to settle down in stages.If the Fed hikes before Xmas this could actually damage the mild recovery in place in the US and delay the above sequence of events.

FACT BOX The irrelevancy of monetarism

The monetary policies of the G3 are based on the notion that increases in money stock cause prices of goods and of services to rise. This, in its turn, is based on the Quantity Theory of Money expressed in the “formula” MV=PQ where M Is money, V is velocity of circulation, the speed by which people spend M, P is prices and Q the physical quantity of goods. Now if Q changes slowly and V is very stable, then increasing M will increase prices. Nothing further from the truth in post 2007, as V proved to be unstable and rises in M pushed up the P of assets but NOT of goods and services. Also no one agreed on the definition of M!

Fig 2: Forex rates and USD index,2014=100

Source : Bloomberg

Inflation, forex and investment

Figs 1 and 2 summarise the concerns we have already outlined.In Fig.1, US core PCE, favoured by the Fed, is not anywhere near the 2.0% mark (dark brown) and neither is the full PCE (red).For Japan the full CPI has fallen to deflation again(yellow) while the core (light green) is well below the 2.0% target too.The EU inflation does not show any sign of recovery (blue) while the core (dark green) is not reaching 1.0% .With such weak inflation after all the “monetarist” initiatives, it is a sign of desperation that the BoJ and ECB will try more of the same while the Fed is giving up.On the forex side, Fig.2 tells the tale of EMK rates, some of them very weak (RUB, BRL) some doing better than headlines (IDR) and with the CNY “devaluation”,being but an insignificant blip,but which,amazingly, caused the markets to collapse again.**Moral of the tale**, hiking USD rates will not help inflation and by making he USD stronger will add to instability in some EMKs.**To repeat and sum up our conclusions and investment conclusions**: As we expect that the Fed will not hike till later in 2016, we expect slow recovery to start in 6 to 9 months’ time.In-between expect volatilty and stay off equities and more in cash.Some Asians might perform better as they have been resilient (S.Korea, Philippines), the AUD coud benefit from the, still, lower USD rates, while bund yields could fall more because of low inflation, more ECB boost and return to some normality.Not a lot here, but at least we will not all die !Andrew Freris (writing concluded 29 Sept.2015)