

Tightening of financial conditions

As always when there are sharp moves in financial markets, risks of a persistent tightening of financial conditions rise. This means financial markets move so much that the turmoil starts to spill over to the real economy. Among the things we watch are stronger currencies (reducing export competitiveness), wider spreads (increasing borrowing costs) and weaker equities (potentially hurting both investment and consumption). Most immediately, points out Phil Poole, Deutsche AM's Global Head of Research, "The thing to watch is the wealth channel."

Here, of course, the same logic holds as for the boost to household consumption from lower energy prices. Remember that the key assumption concerns how much of any change in wealth or household energy expenditure translates into changes in consumer spending. The same is true for the wealth effect, and again, there are no cast-iron rules on this. For the U.S., for example, past data suggest some 60% as a rough indication of how much of any increase in disposable income from lower energy costs boosts consumption, but there is a fair amount of variation in the data. Estimates for the wealth effect are much lower. The main reason is that energy makes up for a bigger portion of spending by poorer households (who are more likely to spend the money they save on energy than richer households), while financial wealth is concentrated among richer households (whose spending habits tend to be fairly stable). On balance, we still think it is unlikely for wealth effects to dominate. It would take a broad and sustained market sell-off to reduce wealth by enough to outweigh the small, positive effect lower oil prices would otherwise have on consumption.

From a U.S. perspective, moreover, some financial conditions are actually tightening less than last year. For the moment, they do not seem to have a strong negative effect - despite recent market volatility. In addition, the U.S. dollar has held up fairly steadily against developed-market currencies in recent weeks. In part, this is probably because lower oil prices "further delay the stabilization and gradual rise in inflation", notes Josh Feinman, Chief U.S. Economist at Deutsche AM. Already, the fall in oil prices and the turbulence in financial markets have reinforced doubts among investors about the speed and extent to which the Federal Reserve will increase interest rates further. This has reduced upward pressure on the U.S. dollar, especially against the euro. And it will also make monetary policy even trickier - on both sides of the Atlantic.

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