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Tight fiscal policy alongside ultra-accommodative monetary policy

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On the one hand, risk assets are cheap (relative to recent history) and policy makers are engaged with monetary policy being eased globally. This is often a period characterised by very strong risk asset returns. At the same time, however, the leading indicators of growth are deteriorating and structural developments in Europe as well as the 'fiscal cliff' in the US remain deeply concerning.

Ultimately, the 'winner' of this struggle will be determined by whether there is another global recession or not. Global growth has slowed to a very weak pace and the leading indicators of economic growth are weak and highlight increased recession risk. While policy makers are responding to this possibility by easing monetary policy the efficacy of this policy response is doubtful when interest rates in the major developed economies are at zero or close to zero.

In addition, fiscal policy is being tightened across continental Europe, the UK and the US in an attempt to address an unsustainable fiscal outlook. The UK is the clearest case of the current policy mix of very tight fiscal policy and very easy monetary policy and that economy is in recession which is a discouraging portent for the major developed economies.

Our expectation continues to be that even if recession is averted, risk assets are vulnerable in the near term to, at the very least, pricing in a greater risk of a recession. After all, despite all the angst, risk asset returns have been robust so far this year. The US equity market and the German equity market in particular have carved out double digit returns so far this year.

Most other equity markets are positive year to date (with the notable exception of the Spanish and Italian markets). Credit markets are also performing well and 'risky' currencies (commodity and emerging market currencies) are strong despite significant weakness in 'hard' commodity prices.

A by-product of the policy response by central banks has been an intensification of the search for yield with reasonable credit ratings. As a result, European sovereign bond markets have become dysfunctional with short term yields (out to two years) in many countries negligible or negative while in the distressed periphery (including Italy and Spain) two-year yields are 4% or more. And yet all of these economies have the same cash rate of 0.75%.

Spain's credit rating is currently under review by Moody's and they are in danger of being downgraded below investment grade which would cause major ructions in sovereign bond markets. Germany and the Netherlands have also been put on negative watch by Moody's as it becomes more likely that the eventual solution to the crisis involves some mutualisation of peripheral debt.

Late in the month, the President of the European Central Bank (ECB), Mario Draghi, promised decisive action. Two months ago, he was calling for a 'bold leap of political imagination' in order for European integration to survive. We doubt very much that the European Summit at the end of June constituted that leap, but it appears that the ECB is prepared to take some action to buy some more time in the hope that the politicians eventually deliver.

The US Federal Reserve (the Fed) is also under pressure to ease monetary policy further even though they just announced an extension of 'Operation Twist' at the June meeting. The focus and hope of the markets is that the Fed embarks on QE3 with a further balance sheet expansion. The pundits are convinced that this would prompt a tradable equity rally and they are probably right as long as the US averts recession. The testimony of the Chairman of the Fed, Ben Bernanke, to the Congress late in the month seems to indicate that while further easing is being considered they are probably not yet ready to adopt QE3.

Another by-product of the search for yield and the chronic lack of conviction of investors is that volatility has subsided to low levels across equity, bond and currency markets. Spain and Italy have always been considered 'too big to bail' and 'too big to fail' and yet the prospect of the Spanish government losing access to the bond market is causing very little, if any, contagion into risk assets more generally. This lack of contagion and fall in volatility betrays an incredible complacency. Given the risks posed by the European crisis and the looming fiscal cliff in the US we think it very unlikely that this fall in volatility will be sustained.

In China, the data appear to be consistent with a soft landing, but there is no sign yet of the expected re-acceleration of growth in the second half of this year. This view is confirmed by 'hard' commodity markets which remain under pressure with iron ore prices falling significantly again in July combined with weakness in coal and base metals.

By contrast, soft commodity prices have soared as a result of a severe drought in the US. This will mitigate some of the global disinflationary pressures in evidence so far this year globally – most notably in developing economies where food has a greater weight in consumption. Global inflation outcomes are still expected to be very subdued, however, allowing central banks to ease policy further in response to weaker growth.

The outlook continues to be marked by significant event risk in Europe. In the next two months there are elections in the Netherlands (where anti-Euro parties have a significant share of the vote in a proportional representation system); the German constitutional court decision on the validity of the European Stability Mechanism; Moody's ratings announcement on Spain; ongoing developments in Greece; and the exact shape of the ECB's promised policy response.

In addition, the global economic cycle is delicately poised with growth having slowed to its weakest pace in the recovery and the leading indicators highlighting further downside risk. Against this backdrop and with implied volatility in equities, bonds and currency markets at or near 4-year lows we continue to be of the view that downside protection through options is attractive.

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