

Letter to investors

Central banks – drivers and driven

For a long time, central banks have been driving markets ever higher. But there are limits to their power and political priorities are also important.

Both the power and powerlessness of central banks can be observed on three continents at the moment. Let's start with crisis-ridden Greece. After several "final deadlines" had passed, only one measure promoted a real sense of urgency: the decision by the European Central Bank (ECB) not to increase Emergency Liquidity Assistance (ELA). Had ELA been cancelled completely – for example if ECB debt had not been serviced – a few bank holidays wouldn't have been sufficient to save the Greek banking system. But this also demonstrated the ECB's powerlessness because it ended up being forced to act as a vicarious agent for political objectives, being no longer able to take its decisions autonomously and based on its own set of rules.

Compared to the few hundred billion euros at stake in Greece, the People's Bank of China (PBoC) had to fight against a far bigger monster – the local stock market with a market capitalization of \$7 trillion (down from a peak of over \$10 trillion in June). The Chinese central bank does not, at least, have to pretend to be politically independent. But since the PBoC could not cope with the situation alone, it delivered only one of the many weapons which Beijing fired at the erratic stock exchange. Whether the market downturn was a systemic risk is doubtful – only 5% of financial assets held by the Chinese are equities, and even after recent falls the domestic stock exchanges are still up by double-digit levels year-to-date. The situation on the Hang Seng China Enterprises Index (HSCEI), which is key for foreign investors, is different. This index is now at a similar level to the start of 2015 and could, in our view, offer opportunities in the second half of the year due both to valuations and a likely re-acceleration of the Chinese economy.

/// High debt levels and volatility are a dangerous mix. ///

The U.S. Federal Reserve Board (Fed) has also had to devote more attention to capital markets than to inflation for quite a while. Just a few weeks before what has widely been viewed as the most probable date for a first rate hike (September), the Fed either does not want to – or is not able to – commit itself. But what is the Fed's scope for action after all? Like many major central banks, it is struggling with the ripple effects of the crisis. How should it manage a return

to "normal" in an environment of sluggish growth and debt levels that are even higher than before the crisis? Whatever your opinion on easy money, one negative side effect is certain: highly leveraged economic entities and capital markets are more susceptible to market fluctuations – and by their own actions may even reinforce them. This might be the reason for the central banks' continuing desire to quickly nip economic downswings in the bud by providing extra liquidity. In the long run, however, an economy's health will suffer without the purging effects of economic cycles.



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