



the whole of the EUR, GBP and USD complex are mostly considerably wider than where they were at the start of the last two years at least. Indeed as we'll see in this piece, some areas of the market (mostly USD credit) are trading at what we would call 'the edge of normality' – they've only been wider for periods where you've had a genuine crisis rather than simply a sell-off.

The recent volatility originally stems from a stronger dollar, weaker Chinese growth, weaker commodities and expectations of the start of a Fed hiking cycle. However it quickly morphed into a China crisis as the equity bubble burst and the authorities there were perhaps inconsistent in their subsequent interventions with it being unclear at various points whether they would prevent further falls or let markets find the clearing level. As uncertainly over the economy simultaneously grew, the devaluations in the 2nd week of August sparked a mini currency war/panic in EM and suspicions of further skirmishes to come even if China's motivation could have genuinely been to attain SDR status with the IMF. At the moment there is no clarity as to what China's short to medium term policy objectives/tools are. This has created confusion. This all then came to a head in the worst month possible - i.e. at the peak of holiday season - in what are already lower volume trading markets due to increased banking regulations. The knock-on effects have therefore been amplified. This provides opportunities if you think a global growth slowdown can be avoided for now.

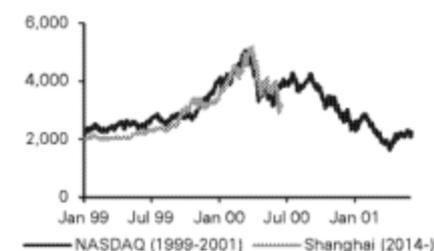
So what happens next?

Well the Fed is now (on balance) expected to relent from a September hike and possibly for much longer in our opinion. China is likely to have to find ways of stimulating/intervening further and it's not inconceivable that the ECB and BoJ will eventually increase their already extreme money printing operations as inflation continues to frustrate on the low side. So we don't think it's the end of the central bank liquidity era yet and as such we would want to continue to have a bias towards owning credit product even if we think the global financial system is extremely flawed. Clearly the main near-term central bank focal point is the Fed. What happens if they do decide to raise rates?

Should we worry about a Fed hike if it does happen?

History tells us we shouldn't worry for at least 12-18 months. Figure 5 shows what happened to US BBB spreads in the three years before and after the first and last hike in the last 12 hiking cycles stretching back to the early 1950s. As can be seen, spreads tend to tighten on average for 12 months after the first hike in the cycle before reversing course over the next two years. This perhaps shows the usual lag of monetary policy on financial markets and the economy. This is backed up by the graph on the right showing that the last hike in the cycle is generally followed by widening credit spreads.

Figure 4: NASDAQ 1999-2001 vs. Shanghai Comp 2014-



Source: Deutsche Bank, Bloomberg Finance LLP