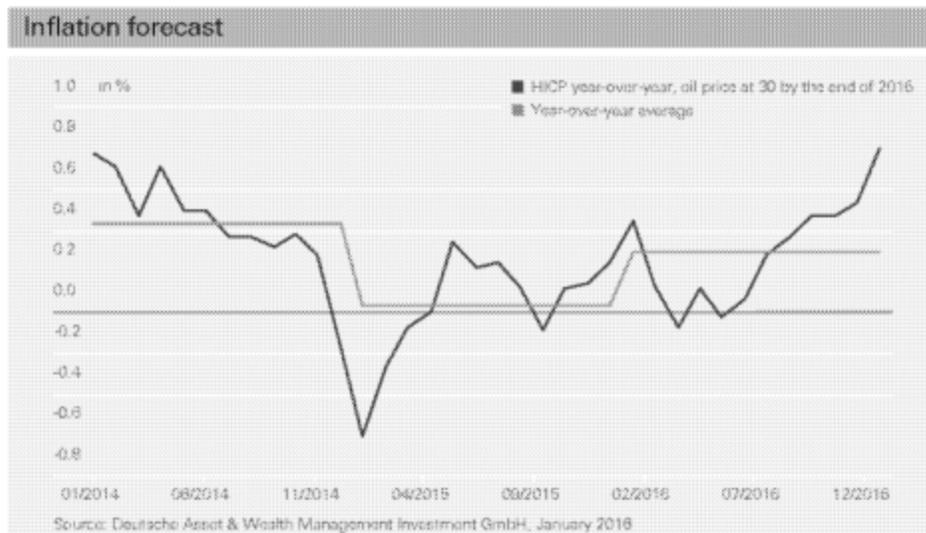


Monetary policy

For the European Central Bank (ECB), less dollar strength than expected is unwelcome, as Mario Draghi, the ECB's president noted on January 21. Amongst other things, it means that the fall in the oil price will continue to have an even more negative effect on headline Eurozone inflation figures. Even at constant exchange rates, the recent fall in the oil price means that energy will continue to be a bigger drag on Eurozone prices for longer than previously thought (see chart below).



How low could Eurozone inflation go?

Lower oil prices would delay the rise in Eurozone inflation by pushing down the cost of energy in year-on-year comparisons. We have been expecting an increase of 1.2% for 2016, but acknowledge the downsides to this scenario. If oil continues to trade around current levels and ends the year 2016 at \$30/b, we would expect average year-on-year increases of just 0.3% in the Harmonised Index of Consumer Prices (HICP). HICP is the indicator of inflation and price stability preferred by the ECB. The ECB targets inflation rates of below, but close to, 2% in the HICP.

Rightly or wrongly, this risks causing renewed deflation fears if oil falls further. At least in the short term, it is hard to see what the ECB will be able to do about this, apart from offering reassuring words that it remains ready to provide further stimulus, as Draghi has already done.

And this, perhaps, gets to the core of the problem. The boom in U.S. shale exploration did not come out of the blue. Instead, U.S. energy was one of the many beneficiaries of the increasingly desperate search for yield we have seen in recent years. Just as central banks in industrialized countries had hoped when they embarked on QE, higher prices for relatively safe investments such as government bonds drove investors into ever riskier assets. As we will see below, emerging markets were another favorite destination, leading to sharp increases in debt levels, especially in the corporate sector. In turn, debt-fuelled growth in emerging markets, notably China, helped boost demand for oil and other commodities.

It is probably no coincidence that within weeks of the Fed implementing its first hike, both oil and emerging markets have become major sources of volatility. This also provides new ammunition for skeptics of QE programs, worried about the longer-term implications for capital allocation and economic stability more broadly.

Past performance is not indicative of future returns. No assurance can be given that any forecast, investment objectives and / or expected returns will be achieved. Allocations are subject to change without notice. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect. Source: Deutsche Asset & Wealth Management Investment GmbH, as of 02/2016