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The third wave of deflation is over

Developed economies have stood up well to the latest wave of deflation emanating from emerging economies that has seen a combined volume and price shock depress global trade and output.

This third wave of deflation (coming after the financial crisis of 2008-9 and the European sovereign crisis of 2011-12) is now over, as is the period of dollar appreciation which was tightening financial conditions.

Indeed, dollar strength has ultimately acted as the catalyst for much-needed central bank coordination that is now easing financial conditions. Fears that the US might enter a recession now look exaggerated and I expect another up-leg in the bull market in US equities.

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CENTRAL BANK COORDINATION IMMEDIATELY EASES FINANCIAL CONDITIONS

Central bank actions have provoked justifiable criticism in recent months from many quarters. I argued previously that we were in a situation where communication errors were unnecessarily contributing to tighter financial conditions and equity market volatility. Specifically, I felt the US Federal Reserve (Fed) were much too forceful in signalling that money markets were underestimating interest rate rises in 2016.

The strength of the US dollar has been the main channel through which global financial conditions have tightened in recent years. Since global financial markets and commodities are priced in dollars, the upward move in the dollar meant that the value of the same assets priced in stronger dollars had to fall. Now, the reasons for the appreciation of the dollar are many, so it is not something that can be pinned solely against the Fed, but since only the Fed can print dollars, it does have the ultimate responsibility for ensuring that the currency does not become a constraint on activity.

Unfortunately, as the dollar continued to appreciate, we experienced a challenging period when central banks were effectively pursuing their own domestic agendas. This was a mistake. Fortunately, we are now seeing a clear recognition that the net effect, or more rightly, the unfettered consequence of independent actions saw the dollar reach a level that was a threat to financial stability. Recent actions by central banks suggest a greater level of coordination with respect to currency than we have seen for some time. While we are not talking about something akin to the formal *Plaza* or *Louvre* accords of the 1980s, there now seems to be an important recognition between the major central banks that no one stands to benefit from further dollar appreciation.

The People's Bank Of China (PBOC) has been explicit that the renminbi will not be devalued and the PBOC's actions in the foreign exchange markets certainly support that position. In Europe, the nature of the expansion of the European Central Bank's QE programme suggests that Mario Draghi is refraining from using the foreign exchange channel. He was clearly concerned that the easing stance and move to negative rates would be seen as an opportunity to short the euro. As a result, he very deliberately used the press conference to say there would be "no more cuts" to rates. This had the intended effect of reversing euro weakness.

The Fed meanwhile has had to move back from its overly vigorous position on the path for interest rates that it laid out in December. The revised position (moving from four rate increases this calendar year to two increases; see chart 1) is now aligned with market expectations and we have seen a downward move in the US dollar as a result.

I don't think the post-Fed meeting weakness in the US dollar is the start of any material depreciation trend, but I do think that the period of dollar appreciation we have been witness to over the last few years (and particularly since mid-2014; see chart 2) is now at an end. This immediately eases financial conditions and should allow elevated volatility levels in financial markets to subside.

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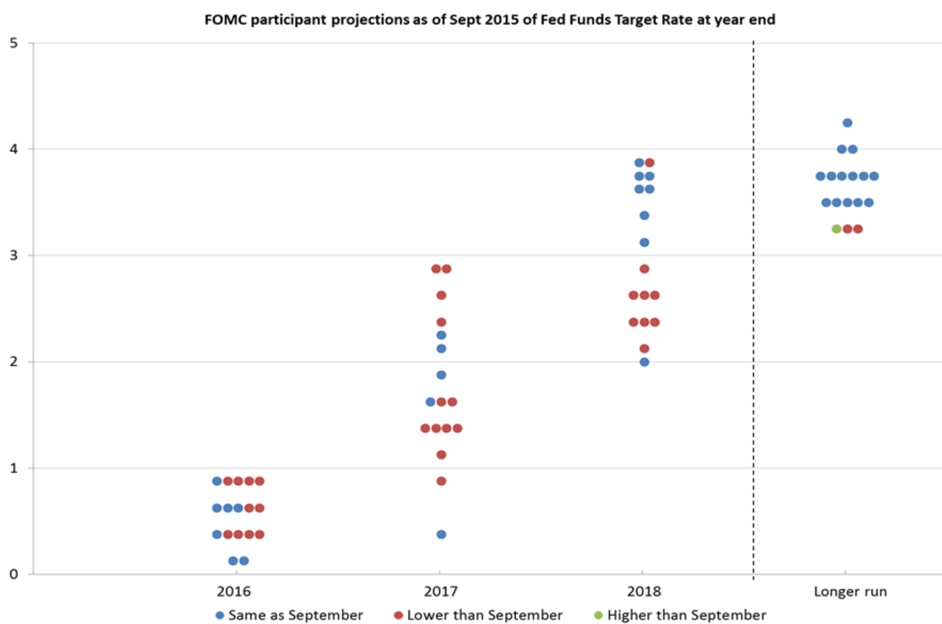
Chart 1. Downshift in Federal Reserve's expected path of interest rates



Source: US Federal Reserve, March 2016

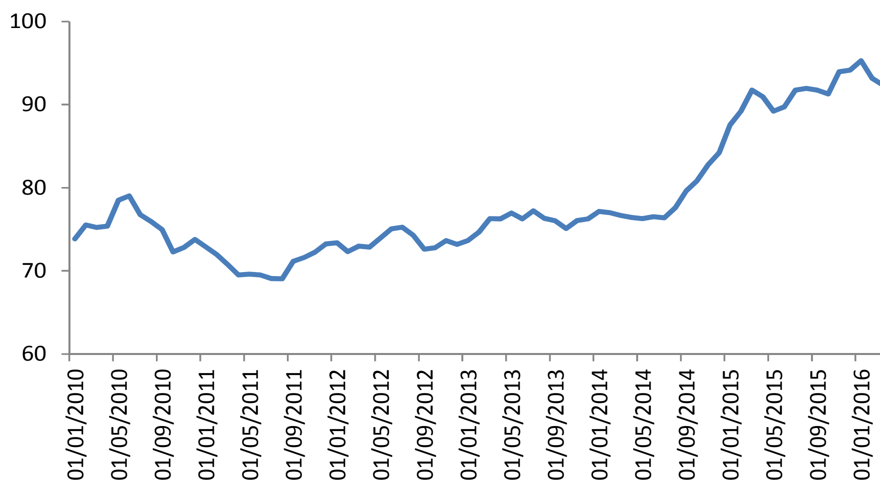
DEVELOPED ECONOMIES HAVE BEEN RESILIENT TO THE DEFLATIONARY WAVE

At the same time as financial conditions ease, it's becoming increasingly clear that developed economies have actually weathered the effects of the third wave of deflation pretty well. Yes, we have seen a volume and price shock in traded goods and industrial production but the US domestic economy has continued to perform well, and the Eurozone and UK have also held up reasonably well. In my view, the fears of only a few weeks ago that the US might enter a recession were greatly exaggerated.

Instead, I believe we should now enjoy a period of stable growth with benign financial conditions providing the platform for a new up-leg in equites, once again led by the US stock market. A Chinese devaluation would be a risk to this thesis, potentially supplying yet another deflationary wave, but this risk appears to have materially subsided.

The recent bounce in emerging markets and commodities from distressed levels will most likely fade as both areas still face pressing structural challenges, which will take years to work through. Instead, I see leadership reverting to those areas least impaired by recent developments; that is the sectors with high levels of intangible assets and intellectual property, such as information technology and healthcare.

Chart 2. End of an era: trade-weighted value of US dollar against major currencies



Source: DataStream, March 2016

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