Lloyds Chambers
1 Portsoken Street
London E1 8HZ
Tel: 020 7702 0888 Fax: 020 7702 9452
www.hermes.co.uk

PRESS RELEASE **06 AUGUST 2014**

US – THE 'PERPLEXING' LABOUR MARKET

In his August economic outlook Neil Williams, Hermes Group Chief Economist, investigates the 'perplexing' US labour market:

As the Fed's QE tapering comes to an end, activity bounces back after Q1's blizzards, and even the labour market begins to warm up, financial markets have for the first time since the crisis brought forward expectations of the first Fed rate hike. They now expect a 25bp rise to 0.5% around mid 2015, then a further 50bp by the end of 2015.

The Fed's dual mandate will keep it fixated on the labour market
We have long expected the start of the US's rate tightening to be deferred to H2 2015, as FOMC 'doves' like Janet Yellen put the vagaries of a "perplexing" labour market and post-blizzard recovery ahead of an inflation rate set to stray modestly above the Fed's 2% medium-term target. So even in 2015, expect only 'baby steps' to normalisation, leaving real policy rates negative to 2016.

This means that, after five years already of negative real rates and the Fed having done no more than signal the end of QE, markets should expect a continuation of its relatively loose policy.

Contrary to the perception that tapering is tightening, the Fed has injected fresh liquidity at a time when private-sector GDP is growing over 3%yoy, NBER-defined recession ended five years ago, and the unemployment rate is falling as we go into November's mid-term elections. In a $17trn nominal GDP economy, tapering has been equivalent to an extra 3%-of-GDP economic stimulus.

Yet, real US GDP is 6.5% higher than its pre-crisis level - even after Q1's 0.5% blizzard-induced drop - and underlying growth lies close to its 2.5% 'potential', after which inflation pressures typically build.

The FOMC's dual mandate will though, keep it fixated on two key growth variables. First, a *"jobs recovery* (that) *has been disappointingly slow"* (Yellen). The unemployment rate has this time taken two-three years longer to fall to the same levels in previous recoveries. Payroll gains have been muted, having taken over two years for the underlying run-rate to creep back above 270,000 per month.

Many may never return to the workforce
But, wage pressure may soon build. The lower unemployment rate since 2009 reflects not so much job gains, but a drop in the 'participation rate'. This tracks the labour force as a share of the working-age population, and it has plummeted to a 36-year low (see chart below). This is the lowest in five recessions. Its drop is the mirror image of the UK's rise since 2012 - the UK's reflecting *inter alia* deferred retirement, and tax incentives relative to benefit payments.

For the FOMC, about three quarters of the US's fall reflects retirees, and an 'easier' take-up of disability payments after a relaxation of the rules. On the basis these participants are in general unlikely to re-enter the workforce, this offers hope for wage growth. Their departure removes a pool of labour that would go some way to easing skill shortages. And, the rate's stabilisation now around 63%, while low, suggests disaffected workers may be returning to job search.

However, the risk is that with productivity little improved by their absence, bargaining power may need longer to revive. Therefore, until the implications for wages are clearer, the FOMC will sit on rates.

Then there's the additional stimulus from greater US self-sufficiency in oil and gas, and the fact that US strategic reserves are at a record high. There seems little coincidence that the usual, one-year lagged hit to US unemployment from higher real oil prices appears to be waning. If so, this eases one potential risk to hiring.

The second distraction for the FOMC are house prices, which have been rising in real terms for over two years. As a pillar of the private-sector led recovery, any sudden jolt to housing would be an unintended consequence of normalising rates. The Fed is still mindful that average 30-year mortgage rates leapt after Bernanke's 'taper-gate' warning in May 2013. And, his 'cold feet' last September will have reflected the FOMC's unease about further mortgage-rate rises.

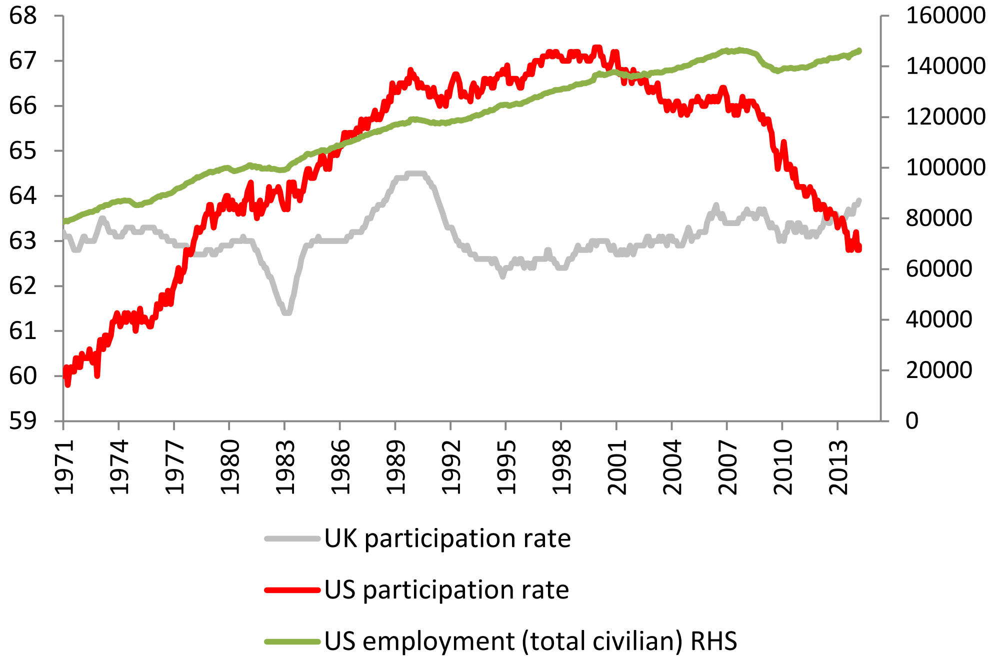
But, having done QE, the Fed, like the BoE, is acting from a position of strength. It now has a second lever to pull to take money out the system, by virtue of its $4.4trn in asset purchases. With QE (untried between 1951 and 2008), the Fed can this time raise rates in tandem with reductions in its stock of Treasuries/MBS, via 'quantitative tightening' (QT). The Fed (like the BoE) hints QT will come once rates are higher. This should help cap the (more visible) peak Fed funds rate.

Our analysis suggests the Fed will ultimately have to sell back approaching one fifth of its Treasuries/MBS as a *quid pro quo* for capping the Fed funds interest rate target at the 4% inferred by some FOMC hawks.

As a result of all this, investors in 2015 should brace for higher US policy rates. This will, as usual in tightening cycles, test market valuations. Yet, if we're right about lower peak rates and 'QT', this should offer some support to equities and other growth assets, relative to conventional bonds. Once, that is, the labour market becomes less perplexing.

But, it's not just about employment - it's participation too

US & UK participation rates (%), vs US civilian employment (thousands)



Source: Thomson Reuters Datastream, based on BLS, & ONS data

Ahead of the Curve is a monthly economic outlook produced by Hermes Group Chief Economist, Neil Williams. Current and previous versions are available online: https://www.hermes.co.uk/

ENDS

Hermes Fund Managers

Jeannie Dumas
+44 (0)20 7680 2152
j.dumas@hermes.co.uk

Melanie Bradley
+44(0) 20 7680 2218
m.bradley@hermes.co.uk

Notes to Editors:

Hermes Fund Managers
Hermes is focused on delivering superior, sustainable, risk adjusted returns for our clients – responsibly.

We believe in **Excellence**, **Responsibility** and **Innovation**

- **Excellence:** We aspire to excellence in everything we do. This manifests itself most visibly in our investment performance. We will only offer products to our clients where we believe there is a strong investment thesis and where we can deliver sustainable alpha.

- **Responsibility:** We believe it is our responsibility to lead discussion and debate about the fiduciary responsibilities of fund managers to our clients, their stakeholders and, ultimately, society at large. We have always sought positive engagement with the firms in which we invest.

- **Innovation**: We have the entrepreneurial culture to identify forward-looking products that meet those needs, along with the resources and speed-to-market mentality to develop them rapidly.

Our structure provides wholesale, institutional and pension fund clients globally the benefit of access to a broad range of specialist, high conviction investment teams operating within an established and robust operating platform.

Hermes' investment solutions include:

- **Fixed Income**: Inflation-Linked, Government Bonds, Investment Grade, High Yield
- **Alternatives**: Commodities, Hedge Fund Solutions, Infrastructure, Private Equity
- **Equities**: Global, Emerging Markets, Small & Mid Cap, Europe, Asia Ex Japan
- **Real Estate**: Segregated, Unitised, Debt, UK, US Residential, European

Hermes manages assets on behalf of more than 200 clients* across these investment areas with £27.4 billion* assets under management. In Hermes Equity Ownership Services, we have one of the largest engagement resources in the industry, advising on more than £108.6 billion* of assets.

*Please note the total AuM figure includes £3.6bn of assets managed or under an advisory agreement by Hermes GPE LLP ("HGPE"), a joint venture between Hermes Fund Managers ("HFM") and GPE Partner Limited. HGPE is an independent entity and not part of the Hermes group. £0.4bn of total group AuM figure represents HFM mandates under advice. Source: Hermes as at 30 June 2014.