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HERMES ECONOMIC OUTLOOK: 2015 TO BE MORE LIKE 2014 THAN 1994

In his latest Economic Outlook, Neil Williams, Group Chief Economist at Hermes Investment Management, looks into 2015.

While 2014 was about preserving the green shoots of recovery, weathering geopolitical risk, and trying to 'kick the drug' of quantitative easing (QE), more needs to be done in 2015.

The US and UK have spent 2014 pulling themselves clearer of the GDP hole of 2008-09. Yet after six years of unprecedented stimulus the inflation 'genie' has failed to 'leave the bottle'; oil being the latest disinflationary force.

The lesson of 2014 is that QE should be awarded only half marks…
In the euro-zone, the more likely course is deflation, with the risk of 'Japanification' lingering. Added to that, geopolitical risk is building, and, with some big emerging markets slowing (e.g. China), the traditional leg-up for G7 growth is lacking.

The lesson of 2014 was that QE should be awarded only half marks. With consumers and firms stuck in a 'liquidity trap', the inflation that QE has stoked since 2009 came more from asset prices than the direct consumer route hoped for. With wages subdued, it could thus be accused of reaching those that 'needed' it least.

Central banks guarding bloated balance sheets thus seemed too scared in 2014 to scare anyone; their ample liquidity, cheap cash, and soothing words allowing equities and other growth assets to climb. We could see more of this in 2015.

Looking into 2015…
There are reasons to be cautious still on world growth. The euro-zone remains unfixed, and central banks with 'skin in the game' are likely to take only baby steps to normalising policy rates. In this respect, 2015 should look more like 2014 than 1994.
Our macro outlook for 2015 is based on four core beliefs.

First, not only will US and UK real policy rates stay negative to 2017, but 'peak' rates, when they come, will be much lower than we're used to. Critical to completing the recovery 'jigsaw' will be the labour market.

Even now, we have no more than a three-speed recovery. In the fast lane are the US, Canada, NZ, and Australia. In the middle, the UK's GDP is 4% higher than pre-crisis. But, in the slow lane, Japan and the euro-zone are barely back to 'square one'.

Yet, over the same period, wages have not outpaced inflation. US GDP may be 8% up on the deal, but its CPI has risen 17%, and wages 17%. Worse still, the UK's RPI is 23% higher, but average wages are up 12%. Growth will not be surrendered while demand-inflation stays calm.

Given disparate worker participation rates, wage inflation looks more likely in the US than UK. Japan's higher CPI needs to be matched by wages; if it isn't, Abe's progress will be another false dawn.

Second, there's no 'free lunch'. Lower peak rates (we expect no higher than 4% in the US, 3% in the UK) will ultimately be delivered by central banks pulling on their second lever. That is, by running down some of their assets via 'QT' (quantitative tightening).

If right, then the coming years could still provide a constructive platform for equities and other growth assets, relative to conventional government bonds.

Third, markets are at last focussing on the right thing – a euro-zone whose monetary union lacks economic union. The ECB is 'dipping in its toe' with private asset purchases, but, they look small. More potent will be the 'bazooka' of sovereign QE (government bonds accounting for half of all issuance), which comes in 2015.

Until it does, the smell of deflation is building at a time when Germany's 'bullet proof' status economically is being tested by a slower China and Russia. With Russia accounting for two-thirds of Germany's oil/gas imports, and EU demand accounting for one half of Russia's tax-take, logic at least suggests a long-term settlement.

Fourth, there's the emerging markets (EMs), many of which stand to be hit by any large-scale liquidity withdrawal. But, despite higher volatility, this doesn't feel like the start of a 'blanket crisis'. Few EMs now have rigid currency pegs to defend, meaning weaker currencies can be used as a pressure-release, without eroding reserves and risking default.

What could ensue, though, are perceptions of a 'currency war' stretching beyond the G7, to include satellite economies like Australia, NZ, Denmark, and Sweden. Even China is cutting rates, and its productivity collapse may defer renminbi convertibility.

Therefore, QE is far from dead. Even if it has run its course in the fast-growing US and UK, it is accelerating in Japan (even after 16 years), and should play an increasing role in others (euro-zone, China?).

And, should the world in 2015 weigh too heavily on the US recovery, QE even there (to paraphrase Monty Python's famous Parrot Sketch[1]) may be just 'resting'.

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[1] *"No, he's....resting." "Look,..I know a dead parrot when I see one. This parrot is no more. It has ceased to be. It's expired and gone to meet its maker. This is a late parrot...Bereft of life, it rests in peace....It's an ex-parrot."* (Monty Python, 1969)

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