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HERMES CHIEF ECONOMIST: THE US FED GETS READY

In his latest quarterly report, *The US Fed gets ready*, Neil Williams, Group Chief Economist at Hermes Investment Management, sets out his economic outlook for the rest of 2015.

The slide in oil, falling inflation expectations, and temporary bursts of consumer price deflation are a 'double-edged sword'. Central banks hoping to start normalising interest rates this year now have to seek non-inflation reasons. For most, these will be difficult to find.

The exception should be the US Fed, where US real GDP is 10% up on its pre-crisis peak, and whose dual mandate incorporating employment growth offers scope later this summer for their first rate hike since June 2006. We have quantified the trade-off between the US's 2008-09 rate cuts and its QE, to gauge how excessively loose US policy has become. Adjusting for QE in this way, the US is running a *de fa*cto Fed funds rate of about -5%, or as little as -7% in real terms.

US Fed wants to get the ball rolling…

The FOMC will thus want to get the 'normalisation ball' rolling. Its steps will admittedly be nuanced and small, using incrementally more hawkish language before a first, 25bp hike possibly around its new economic forecast in September.

But, even this will be 'sugar coated' by reassurance that the pace of normalisation will be slow and data dependent. On the basis of the US's relative insulation from global economic headwinds, the fall of unemployment into the Fed's 5.00-5.5% 'Nairu' range ('non-accelerating inflation rate of unemployment') and our upbeat growth outlook, more should follow.

UK to tighten the fiscal screw, whoever wins the election...

The BoE's position will be more difficult. UK real GDP may be 5% better, but with wage growth still the missing recovery piece, the MPC's first rate hike looks off the cards till they pass their single, +2%yoy CPI target probably in spring 2016.

This offers a repeat of the mid 1980s, when oil's fall prompted strong growth without inflation, or the 'NICE' ('no inflation, constant expansion') decade to 2003. Hopefully, the MPC will remember the aggressive catch-up hikes that then contributed to the 1990-91 stagflation.

Almost everywhere else, the monetary reins are loosening. The ECB's -0.2% 'line in the sand' now gives the bond vigilantes something to target, and can surely only intensify the global search for yield. Relative to this level, corporate debt, supra-nationals and even US Treasuries and UK gilts (notwithstanding election risk) may seem increasingly attractive.

But anyone expecting QE to quickly fix the euro-zone will be disappointed. Shifts in euro members' competitiveness are still too disparate for that. As in Japan, euro-zone QE could be with us for years to come, with or without Greece in the euro.

Then there's Japan itself, which, in its third year of 'Abenomics', is struggling to maintain the inflation momentum. And, those countries competing, such as China, will likewise resist currency appreciation. We estimate that after double-digit productivity growth between 2000-11, China's productivity ground to a halt in 2012 and is now falling about 12%yoy.

'Currency wars' stretching beyond the developed economies will thus prevail.

But, it will be no 1994…

All this reinforces our view that 2015 will look more like 2014 (which was characterised by preserving recovery with cheap cash and liquidity injections), than 1994, when the Fed's surprise tightening hit most financial assets.

That was a different time. With US growth centred on 4.5%yoy versus 3.25% 'potential', a small output gap, and CPI inflation expected in the +2.5-3%yoy range, the Fed was worried more about 'overheating' than normalisation.

By contrast, central banks now have too much 'skin in the game' to want to take us off guard. The US Fed's balance sheet carries $3 trn of excess reserves. Unless policy shifts are clearly telegraphed, they may feel our pain. This is easier now, given the constant flow of speeches and testimonies. In 1994, FOMC meetings were not even pre-announced.

'V-shaped' inflation recoveries…

But, central bank vigilance will still be needed. Even if oil just stabilises around current levels, base effect means we may in the second half of this year be facing the sharpest headline inflation bounce since the pit of the global crisis. And with the US and UK economies now growing above 'potential', running such negative (QE-adjusted) policy rates may increasingly raise eyebrows.

So, pulling all these strands together, the risk to financial markets later in 2015 may not be that the US Fed and BoE are tightening, but they are falling 'behind the curve'. And, while this may be conducive to equities and other growth assets, conventional bond yields, anchored by central bank support, look unlikely to sell off aggressively.

Read the latest economic outlook from Hermes Investment Management.

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Notes to Editors:

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

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