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Press Release

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ECONOMIC OUTLOOK: JUST LIKE 1994?...

With geopolitical risk higher, Neil Williams, Group Chief Economist at Hermes Fund Managers sees little reason to change his cautious macro view on 2014. Green shoots in the developed economies still need watering, which means central banks dare not yet turn off the liquidity taps. The ECB has yet to turn them on.

Little systemic risk, but no reason to change our cautious macro view…

There are still some dark clouds overhead. One is a euro-zone that's still not fixed, and where the strains could slowly shift from periphery to core. France looks vulnerable, and Germany's less bullet-proof economically if Ukraine triggers contagion and China slows.

Ukraine still provides uncertainty. Without natural energy resources yet with rising commitments it could default, even without a war. IMF help may be limited in US election year, and, if contagious, an IMF donating increasingly to emerging markets risks putting euro-zone borrowers at the back of the queue.

From Russia's perspective, where around half its fiscal revenue comes from oil exports to western Europe, the direct macro benefit from 'taking' Ukraine and risking sanctions seems limited.

The fear of default, currency devaluation, and US tightening may revive memories of 1994, when Mexico's Tequila crisis needed a collapse of the peso and $50bn in US loans, the Yuan was devalued 45%, and the US's sudden rate tightening triggered a bear leg in bonds and sell-off in equities.

On the twentieth anniversary of these events, a recurrence for financial markets does not look imminent. First, despite volatility, this does not at this stage feel like an 'old fashioned' emerging markets crisis.

Far fewer emerging sovereigns now have rigid exchange rate pegs to defend (exceptions include Argentina, Hong Kong), meaning weaker currencies can be used as a pressure release without whittling away reserves.

Second, many have also used previous crises to get their houses in order, with external debt ratios generally lower. Where local debt ratios are higher, because of fiscal expansion and/or political risk, governments can print money, so systemic default-risk looks unlikely.

As does any repeat of the rapid liquidity withdrawal of 1994 from the US. That was a different time:

- with US growth centred on 4½%yoy versus 3¼% 'potential', unemployment falling to 5½%, a small output gap, and CPI expectations in the +2½-3%yoy range, the Fed in 1994 was worried about 'overheating'. Now, many at the Fed are worried that inflation is too low;

- today there is a constant information-flow, including pre-scheduled rate decisions, testimonies, and speeches. This also lessens the risk of a 1994-style surprise, when the timing of central bank meetings was private, and unpublished; and

- critically for markets, with the US Fed and Bank of Japan holding respectively around a quarter of US Treasuries and Japanese Government Bonds, and the BoE holding a third of gilts, and each being the single biggest buyers of their own debt market, central banks now have too much 'skin in the game' to take us off guard.

G5 rate hikes in 2014 are rightly off the radar. Yet, if our macro outlook is correct, US and UK policy rates should start moving up in the second half of 2015. Even then, real rates will still be negative, and the US and UK's overall macro positions way looser than pre-crisis.

Therefore, the risk to markets later in 2014 may not be that central banks are tightening, but that they're falling 'behind the curve'. In the meantime, given the geopolitical risk, this is probably just as well.

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Notes to Editors:

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