HERMES

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Press Release

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ECONOMIC OUTLOOK Q3 2014: RATE HIKES COMING……

Seven years after the first traces of crisis, the exits from ultra loose economic policy are finally drawing nearer, according to Neil Williams, Group Chief Economist at Hermes Fund Managers. We have long been sceptical about policy rate rises, as the G7 struggled to recoup their output lost, financial markets remained fragile, and central banks needed to overshoot on growth and ward off deflation.

Yet, with the US and UK now growing at potential, inflation probably troughing, and policy makers mindful of bubbling asset (especially, house) prices, even we believe rate rises are coming. This suggests at some stage a re-rating by financial markets needing to gauge how severe the interest rate 'normalisation' will be.

We expect it to be gradual and, in the end, relatively limited, with central banks having little incentive to take us off-guard and threaten growth. The UK could hike this November, or if not, next February, ahead of the election; Australia may follow.

However, our base case is that meaningful US and UK rate hikes won't come till 2015. Even then, expect only 'baby steps' back to 'normal', keeping real policy rates negative into 2016.

First, we still have only a two-speed recovery. The US may have reclaimed its output lost by the crisis, but Japan and the UK are barely back to 'square one'. This is at a time when the euro-zone lags, China is slowing and the emerging markets with the highest saving needs look vulnerable. BoJ and ECB rates need to stay on the floor.

Second, growth under these conditions will not be surrendered while 'demand' (core) inflation stays calm. Key to this will be wage growth, which needs faster unemployment cuts before picking up.

Third, central bank messaging will be critical in getting us to the exits without repeating the instability of 1994. With the Fed holding 25% of US Treasuries, the BoE one third of gilts and the BoJ heading for a third of JGBs, they have too much 'skin in the game' to want to take us off guard.

Little wonder the Fed and BoE are talking about 'peak' rates ending up far lower than their historical averages of 5%. We estimate the extent of central bank bond sales after 2015 needed for them to cap peak rates below 'Goldilocks' or 'neutral' levels.

Our *Policy Looseness Analysis* predicts:

- if markets are right to expect up to 75bp in total Fed and BoE rate tightening by the end of 2015, no more than half the US and UK's extreme policy loosening since 2008 will have been corrected.

- adjusting real interest rates (for the Fed's estimate that $600bn in QE is equivalent to shaving 75bp off the Fed funds target and the BoE's estimate that £200bn in QE is akin to taking 150bp off Bank rate) implies respective US and UK policy rates now as low as -5% and -2%.

- on this basis, the Fed and BoE would need to take rates up to 5% and 4% respectively to 'neutralise' policy fully (*i.e.* get to their 'Goldilocks' rates). But, this would get close to threatening Fed and BoE indications that peak rates will fall materially short of their 5% historic averages.

- so, to fill the gap and drain liquidity, the Fed/BoE will have to whittle down their QE-bought assets. But, given the long redemptions profiles, this would take years. In which case, there is no free lunch - and the *quid pro quo* for keeping rates down is the Fed and Bank will at some stage, probably after 2015, have to run quantitative tightening (QT).

Our ***table*** below shows the share of the Fed and BoE's assets that may ultimately need to be sold. As a result, global bond yields should rise, though at least to some extent be cushioned by QE elsewhere. Japan's QE has much further to run, given the threat that Abe's reforms are running out of steam and that demand has again been front-loaded into the consumption-tax hike.

Furthermore, euro-zone QE has yet to start. With demand subdued and the risk of rising bond yields (which sap euro-zone demand), the ECB will have to capitulate, possibly on a GDP-weighted basis to appease the Bundesbank. Otherwise, deflation risk may be compounded by a stronger euro, adding to fears that Japan is leading the way.

Either way, financial markets in 2015 should face higher US and UK interest rates. This will, as usual in tightening cycles, test market valuations. Yet, if we're right about low peak rates and bond sales *via* 'QT', this should at least offer some support to equities and other growth assets, relative to conventional bonds.

To cap peak rates, the US Fed & BoE will probably have to run 'QT'

Implications for US Fed & BoE asset sales from capping their peak policy rates

Market	Current policy rate (%)	Our expected peak rate	*Rate needed to 'normalise'	*Extra tightening required	Implication for QT?
US	0.25% max	**4.0%** *(e.g. Plosser)*	*circa* 5.0%	100bp	**$800bn** *(= 18% of QE stock)*
UK	0.50%	**3.0%** *(e.g. Carney)*	*circa* 4.0%	80bp	**£107bn** *(= 29% of QE stock)*

***Derived from our Policy Looseness Analysis**

Source: Hermes Fund Managers Ltd's Policy Looseness Analysis

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Notes to Editors:

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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
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- **Real Estate**: Segregated, Unitised, Debt, UK, US Residential, European

Hermes manages assets on behalf of more than 200 clients* across these investment areas with £26.9 billion* assets under management. In Hermes Equity Ownership Services, we have one of the largest engagement resources in the industry, advising on more than £103 billion* of assets.

*Please note the total AuM figure includes £3.5bn 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. £0.5bn of total group AuM figure represents HFM mandates under advice. Source: Hermes as at 31 March 2014.

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