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ECONOMIC NOTE **14 OCTOBER 2014**

Hermes Group Chief Economist Neil Williams:

"Today's CPI inflation number, at just 1.2%yoy, is a five-year low, and should cause no headaches for rate 'doves' like BoE governor Carney. The absence of real wage growth - which is still the missing jigsaw piece of the recovery - means today's CPI was always going to play second fiddle to what's happening in the labour market. Aggressive hikes make little sense while real wages are deflating, currently about 2% per annum.

"This probably snuffs out a pre Christmas rate rise. Yet, in coming months, the MPC will be looking to shift from amber to green on rate hikes. Planting the flag early should later help Carney cap the peak rate, when it comes, "materially" lower than its 5% historic average. But, the MPC will take only small 'baby steps' to normalisation.

"First, the UK may have surpassed its pre-crisis GDP level, but remains only in the middle-lane of a three-speed G10 recovery. And, second, the Bank has by virtue of its £375bn of gilts bought under QE too much 'skin in the game' to take markets off guard

"Turning this to its advantage, it (like the US Fed) now has a second lever to pull by, after 2015, raising rates in tandem with reductions in its gilts stock via 'QT'.

"We estimate the MPC would hypothetically need to take rates ultimately to 4% to normalise policy fully: that is, to move to its 'Goldilocks' rate. But, this gets close to threatening Carney's mantra of falling short of the 5% historic average. So, a meaty £107bn erosion of QE will ultimately be needed to fill the gap, thus capping the peak rate after 2015 at a comparatively lower, 3%."

-ENDS-

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Notes to Editors:

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Hermes manages assets on behalf of more than 200 clients* across equities, fixed income, alternatives and real estate, with £27.4 billion* assets under management. In Hermes Equity Ownership Services, we have the industry's leading engagement resource, advising on more than £108.6 billion* of assets.

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*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.