Swiss Re

News release

Fed expected to support growth with stronger statements

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New York, September 17, 2014 – After today's decision by the Federal Reserve to maintain the target Fed funds rate at zero to 25 basis points, Swiss Re's Chief Economist, Kurt Karl, believes that the Fed comments will become increasingly aggressive as growth continues at a strong pace and the unemployment rate falls.

Karl says: "Unlike the soft employment report for August, most economic indicators point to a strengthening of activity. Growth in the manufacturing sector is improving, according to the Manufacturing Purchasing Managers Index (PMI), which rose to 59.0 in August, from 57.1 in July. In addition, the services PMI, durable goods orders, housing permits and unemployment insurance claims have all rallied."

Consumer spending, investment and government spending should also be supporting growth, boosting real GDP growth above 3.5% in the final two quarters of 2014. Income growth has been robust, low interest rates support further investment and state and local governments are spending again. The growth will carry into next year, with real GDP growth of 3.5%. The yield on the 10-year Treasury note is projected to be at 3.0% by end-2014 and 4.0% by end-2015.

He adds: "Fed officials' monetary policy pronouncements will depend on the incoming data – the stronger the data, the more firm the comments will be on a tightening of monetary policy. Growth above 3.5% when the unemployment rate is near 6% will quickly lead to tighter labour markets, forcing the Fed to become more conservative. The first rate hike is still expected in Q1 2015."

In Europe, the opposite sentiment prevails because growth remains anemic and inflation continues to drop. The European Central Bank (ECB) is embarking on a form of Quantitative Easing and is ready to act more aggressively if the recovery falters. It may even start buying sovereign debt. The ECB's first rate hike is unlikely before 2016.

"The economic weakness in the Euro area in the second quarter was an unpleasant surprise and the ECB has already reacted, but it remains to be seen if the action will be sufficient. Growth expectations have been lowered to 0.8% this year and 1.3% next year," says Karl. "Yields on the 10-year German bund will remain very low this year and rise slowly to 2% by late next year, pushed up by a modest increase in economic activity. The weaker euro will help to boost growth."

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Karl continues: "The UK economy continues to outperform, with growth of 3% expected this year and 2.5% next year. Inflation is tame and yield on the UK 10-year government bond is projected to rise along with US interest rates to 4.0% by end-2015."

While recent indicators for the Chinese economy have been mixed, growth is still expected to be close to7.5% in the near term. Defaults on corporate debt remain the greatest downside risk to growth, particularly in the highly leveraged real estate sector. To support growth in the face of an ongoing correction in the real estate market, the PBoC has announced measures to boost lending to the agriculture sector at preferential rates. In addition, investments in clean energy and public facilities will be ramped up.

Karl concludes: "Japan is very likely to recover from the drop in GDP in the second quarter, as the impact from the April 1 sales tax increase abates. The recent weakening of the yen-dollar exchange rate will support stronger export growth, but without more aggressive structural reforms the exchange rate effect will dissipate."

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