Swiss Re

Swiss Re's chief US economist Kurt Karl gives his view on today's Federal Reserve announcement

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New York, 9 August 2011 — 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 US Economist, Kurt Karl, commented: "Economic activity and employment growth have slowed substantially this year, which will delay the initial rate hike by the Fed perhaps even until mid-2013 as they indicated."

He continued: "The Fed's statement, with an added date of mid-2013, is unlikely to soothe markets. Further action will be needed to act as a catalyst to reverse the negative market sentiment. The problem facing the Fed is that fiscal policy is ineffective and the current market sentiment is so negative it could become self-fulfilling with businesses and consumers retrenching and pushing the economy into recession. The S&P downgrade of US debt has put pressure on Congress and the Administration to lower the deficit, dampening growth. Supporting growth are lower gasoline prices, a renewal of growth in Japan, a weak US dollar and low interest rates. But for these factors to become fully effective, market volatility and sentiment must improve. If this occurs, we are likely to have growth of 2.5% for the rest of this year and be at a more robust 2.9% next year. Inflation will fall, even with oil prices at USD 100 bbl. Under these conditions, the yield on the 10-year Treasury note will rise, not due to the downgrade, but because of the modest increase in growth. By end-2012, the yield should be a bit over 3%. Of course, if there is a recession, growth will be negative, inflation very low and yields closer to 2%."

Karl added: "Japan's economy is expected to grow at a rapid pace in the current quarter, 4%+, and this will be sustained into next year with 3.5% real GDP growth, partially fuelled by post-catastrophe reconstruction. The recent uptick in inflation in Europe is already proving to be temporary as oil prices decline. Hence, with the recent spate of global weakness the European Central Bank is expected to be on hold for the rest of this year. The Bank of England is now expected to wait until early next year before its first rate hike. Despite the recent uncertainties and assuming the US avoids recession, Euro area GDP growth is expected to be 1.9% this year and 1.8% in 2012. In the UK, growth will be 1.3% and 1.9% this year and next. Yields on 10-year government bonds are expected to rise modestly by year-end as market sentiment focuses on the moderate growth rather than prospects of a recession. Yields will rise to 3.2% in Germany, 3.4% in the UK and 1.6% in Japan by end-2011. China is already getting inflation under control and is still expected to grow by the robust pace of about 9% this year and next."

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