Swiss Re

News release

Fed's first rate hike may not be far away but jobs and higher inflation are key, says Swiss Re Chief Economist, Kurt Karl

New York, October 29, 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's first rate hike will be primarily dependent on incoming inflation, wage and jobs data.

Karl says: "The key data series to follow for forecasting the first Fed rate hike are core Personal Consumer Expenditure (PCE) inflation, wages and employment. The pace of improvement in these data suggest that the first rate hike is not far in the future."

The Fed's target for core PCE inflation, which excludes food and energy prices, is 2%, and though it was only 1.5% in August, this was up from 1.2% at the beginning of the year. On the wage side, wages for production and non-supervisory workers has risen to 2.3% from its low point of 1.3% in 2012. On jobs, employment growth accelerated to 1.9% in September, up from 1.6% in February. This has been pushing down the unemployment rate, which reached 5.9% in September, down from 7.2% a year ago.

Karl says: "The Fed can still afford to wait, core inflation is below target and wage gains are only pushing up inflation very slowly. However, if real GDP growth strengthens next year, these indicators should all accelerate and the Fed will need to move more quickly than the market is currently expecting."

The unemployment rate is declining rapidly with real GDP growth just over 2%, so 3.5% growth should lower it to 5% and even 4% rapidly, particularly if the potential workers who have not been participating in the labor force remain on the sidelines. Currently, real GDP growth is still expected to be 3.5% next year, based on employment growth fueling consumption and housing starts. The yield on the 10-year Treasury note is projected to be at 2.6% by end-2014 and 3.5% by end-2015.

Economic growth indicators for the Euro area have edged towards stagnation. Meanwhile, headline inflation fell to 0.3% in September, mostly due to energy price weakness. However, core inflation also declined to 0.8%.

Media Relations,
New York
Telephone +1 914 828 6511

Zurich
Telephone +41 43 285 7171

Hong Kong
Telephone +852 2582 3660

Investor Relations,
Zurich
Telephone +41 43 285 4444

Swiss Re Ltd
Mythenquai 50/60
P.O. Box
CH-8022 Zurich

Telephone +41 43 285 2121
Fax +41 43 285 2999

www.swissre.com
@SwissRe

Karl adds: "With growth weak and inflation declining, the ECB is increasingly likely to adopt a public Quantitative Easing policy in early 2015."

In Europe, a rate hike is unlikely until 2017. The European Central Bank's (ECB) policy will also be data dependent, but the economic prospects are much weaker. With the global economy facing divergent central bank policies, the US dollar and the UK pound are likely to become relatively strong. The relative weakness of the euro will help growth in the Euro area, but probably not be enough to quickly change monetary policy. Also, the low interest rates in Europe will constrain an upward movement in long-term US and UK yields, complicating their monetary policies.

Karl says: "After strong growth in the first half of the year, the UK manufacturing PMI declined to 51.6 from 52.5, while the services sector PMI declined to 58.7. The indicators for 3Q remain consistent with our growth outlook of 3.0% for this year and 2.5% next."

The latest economic data for China point to softer economic activity, partially from a deepening of the housing market correction. The government continues its targeted easing policy to support growth, with the People's Bank of China (PBoC) providing additional liquidity to banks and lowering down payment requirements and mortgage rates. Nevertheless, real GDP growth is now expected to be only 7.1% in 2015 – down from 7.4% last month – while it is still expected to be 7.4% this year.

Karl concludes: "Japan has weakened sufficiently for Prime Minister Shinzo Abe to review the upcoming sales tax hike. Without structural reforms, the Japanese economy is unlikely to have a robust expansion. This year it will grow by1.5%, while next year it will slow to 1.2% assuming Abe hikes the consumption tax."

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