Swiss Re

News release

Growth will be stronger than currently expected, says Swiss Re Chief Economist, Kurt Karl

New York, July 30, 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 will soon be hinting at rake hikes because the strong 4.0% growth of the second quarter will continue for the rest of the year.

Karl says: "The robustness of Q2 will continue in the second half of the year as consumption accelerates. Personal consumption expenditure growth was weak in the first half of this year, but with employment gains above 250,000 per month and unemployment insurance claims below 300,000, consumer confidence is high."

Exports and investment growth should also be strong and overall government spending will no longer detract from growth since state and local government spending is rising. Growth will be close to 4.0% in the last two quarters of this year and average 3.5% next year. The yield on the 10-year Treasury note is projected to be at 3.2% by end-2014 and 4.0% by end-2015.

He adds: "The Fed currently remains cautious. Too much talk of growth, asset bubbles, or a need to tighten would spook the markets and perhaps derail the expansion. Thus, the Fed is waiting for confirmation of strong economic activity or inflation before it changes its tone on tightening. But if growth is in the 3.5 to 4.0% range as expected, raising the policy rate will be necessary to dampen growth and inflationary expectations."

If growth and inflation prove to be anemic, the Fed would delay rate hikes into late 2015. However, currently the first rate hike is expected in the first quarter of 2015.

The situation is very different in the Euro area – growth is weak and inflation is declining. The ECB is contemplating additional monetary easing measures. However, since economic activity is improving at a modest pace, it's unclear if any further measures are necessary. A rate hike isn't expected until early 2016.

"The Euro area is likely to grow by about 1.0% this year and nearly 1.5% next year," says Karl. "The not-so-targeted nature of the targeted longer-term refinancing operations (TLTRO) is exerting downward pressure on Eurozone government bond yields as banks may use the

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cheap ECB liquidity to buy government bonds. However as growth accelerates, the German 10-year government bond yield is likely to rise to 1.8% by year-end and to 2.4% by end-2015."

Karl continues: "The UK economy is the bright spot in the European landscape, likely to grow by 3.0% 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."

The Chinese economy remained stable in Q2, with GDP growth ticking higher to 7.5% from 7.4% in the preceding quarter. The improvement was due to government policies, in particular the improved availability of credit to the rural sector and small/micro enterprises. Monetary policy will remain broadly supportive of growth for the rest of the year, with a bias toward funneling funds to targeted economic sectors. Real GDP growth will be close to 7.5% for 2014 and 2015. Nevertheless, credit expansion has resumed and requires monitoring due to the high overall debt-to-GDP ratio.

Karl concludes: "In Japan, Shinzo Abe's monetary and fiscal policies have worked to an extent. The yen is weaker, which has boosted exports, and the fiscal package will help avoid a tax hike-induced recession. It remains to be seen if structural reforms can be implemented. Growth is projected to be 1.5% this year, before slowing to 1.2% next year, while inflation will be above 2.0% this year and 1.5% next year. Interest rates will remain low for the foreseeable future."