

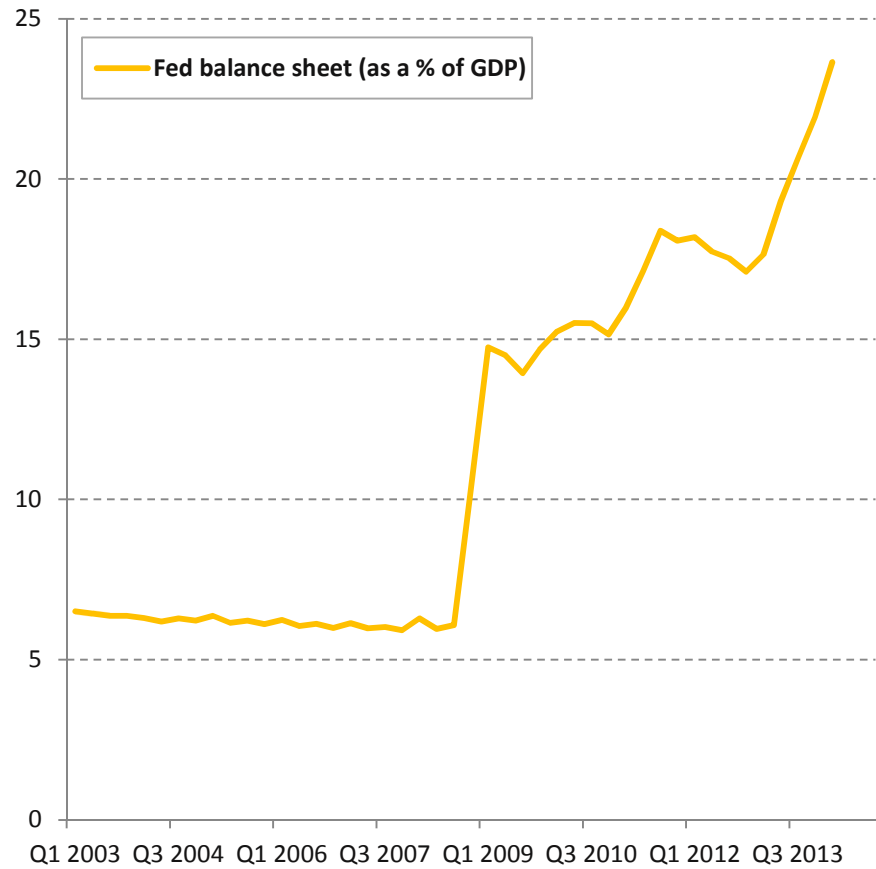
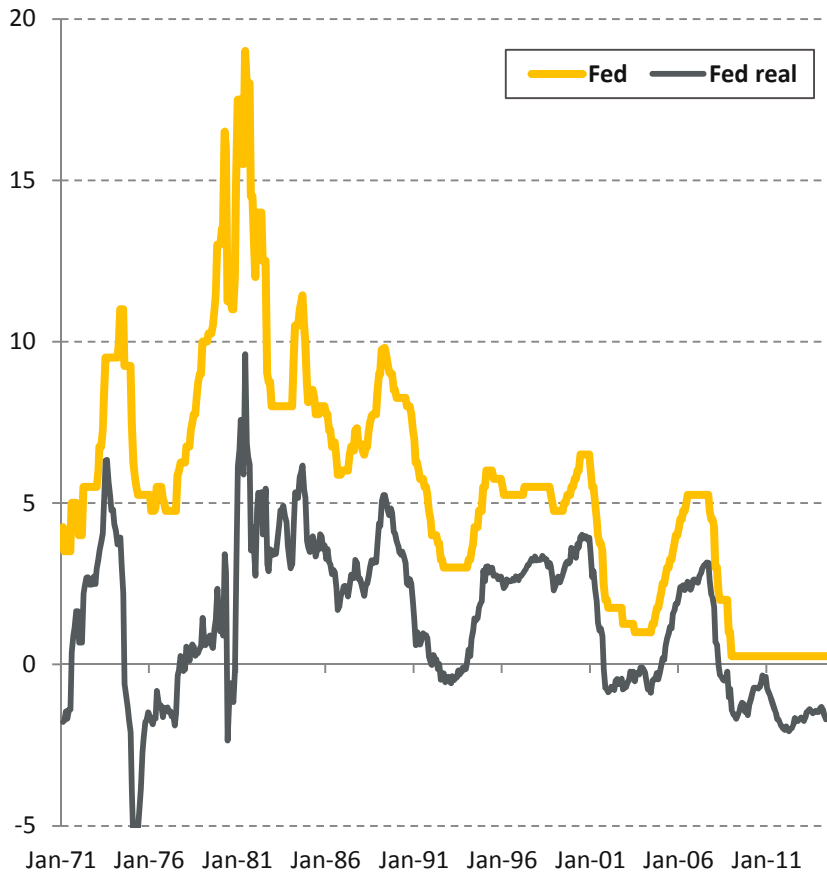


OUTLOOK FOR THE FED

July 14, 2014



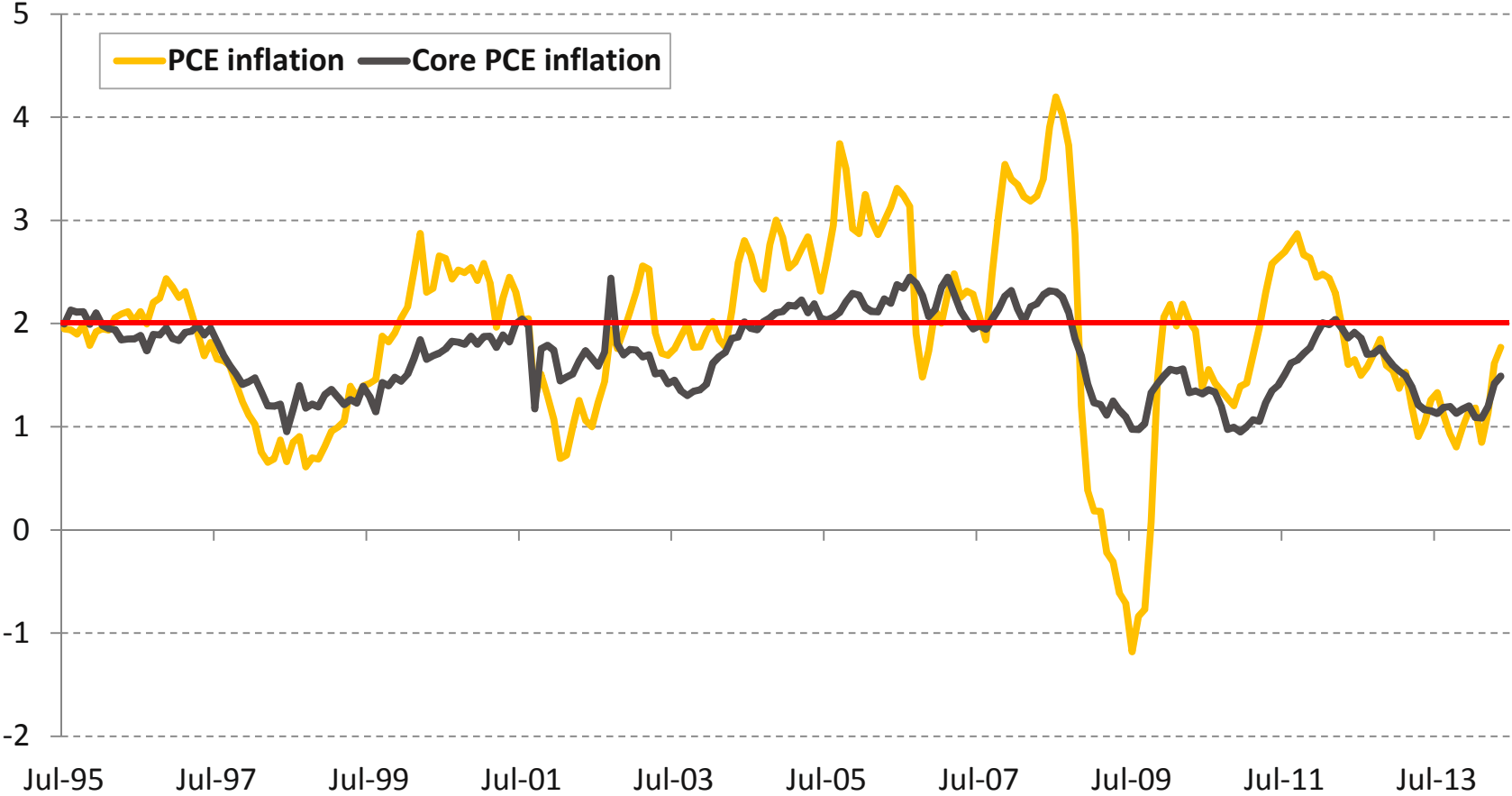
Fed: extremely loose monetary policy



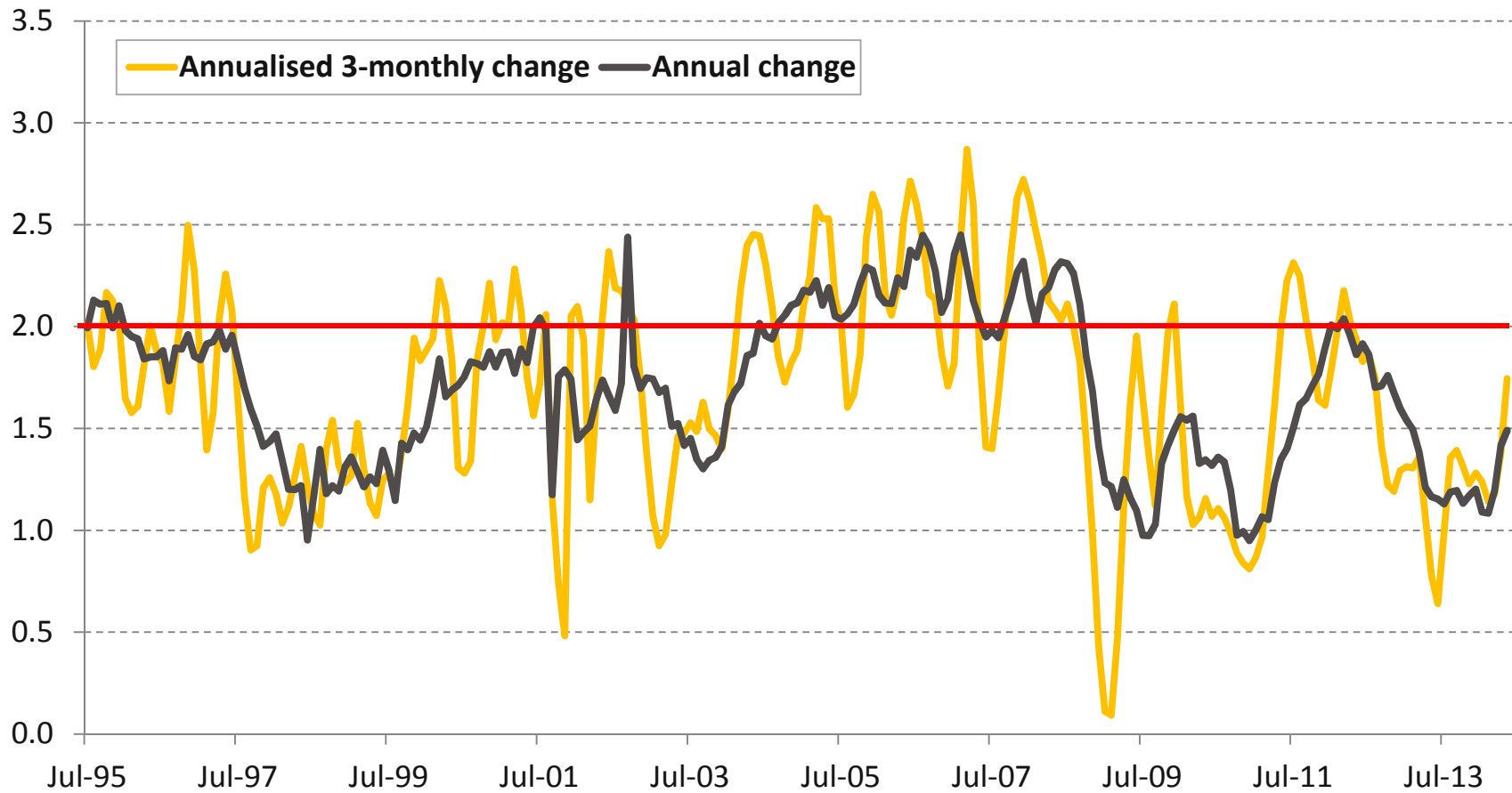
Issues for the Fed

- Inflation
- Wage growth
- Credit growth
- Economic activity
- Slack in the economy
- Bubbles

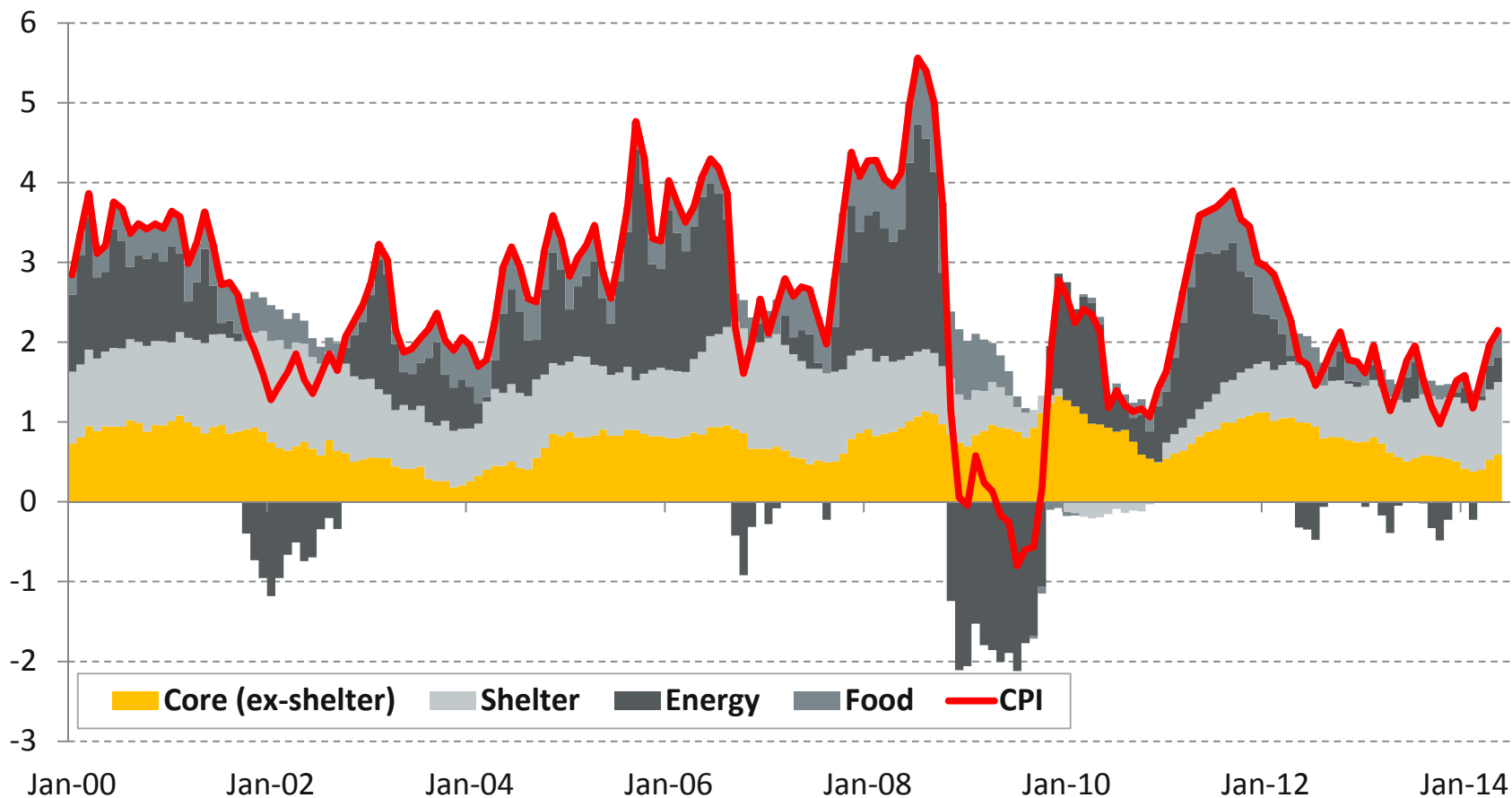
PCE inflation heading back towards the target



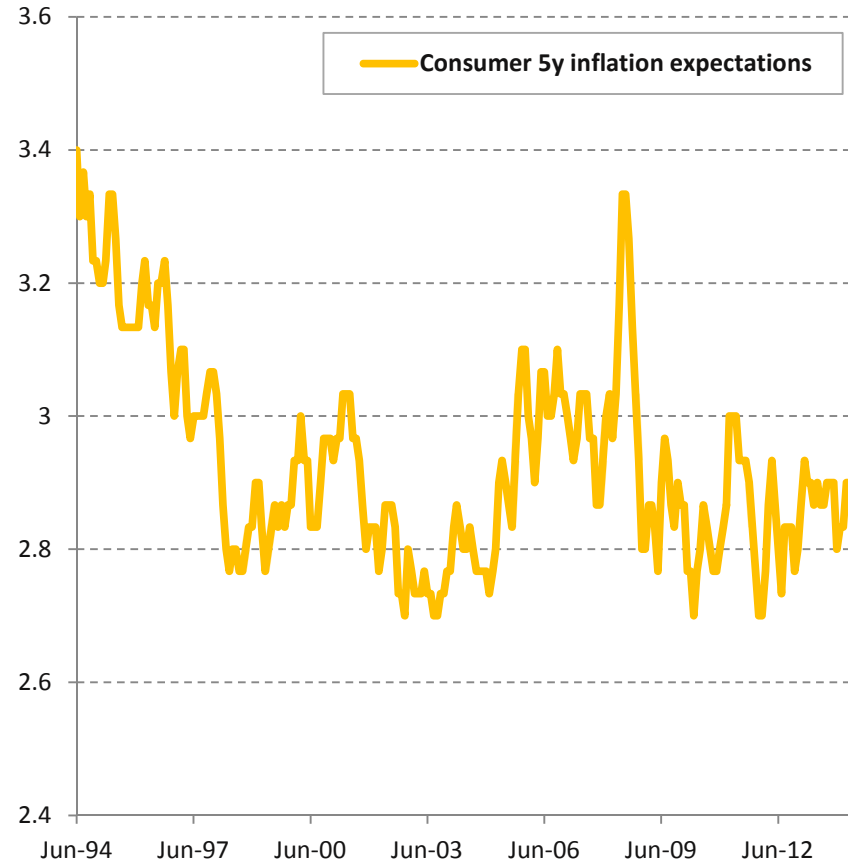
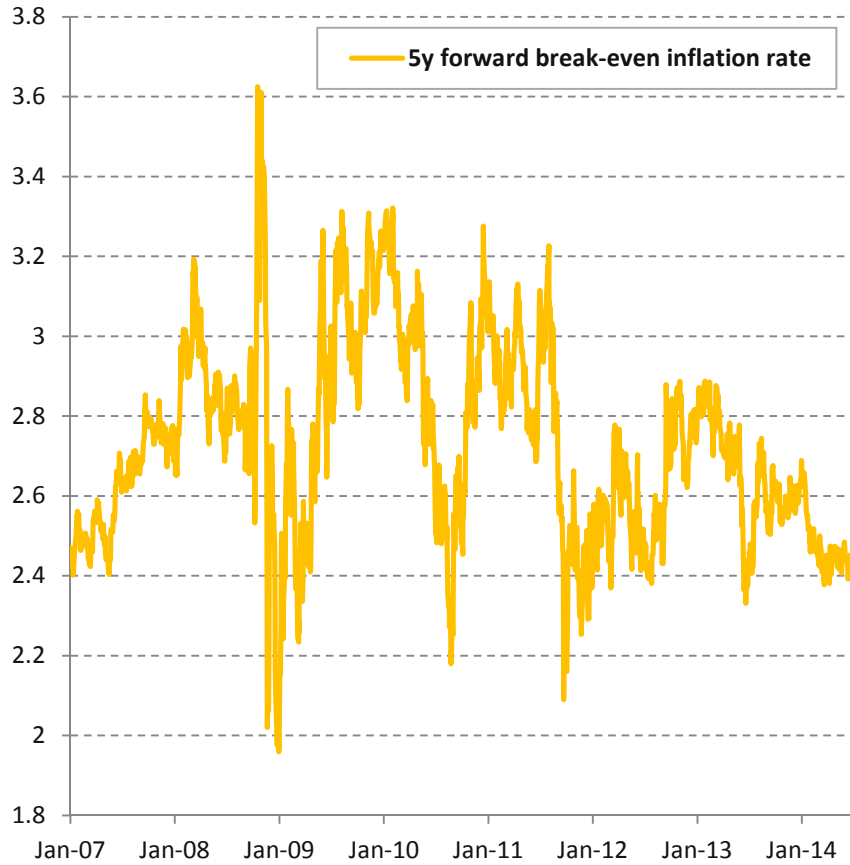
Core PCE inflation heading back to the target



Inflation drivers

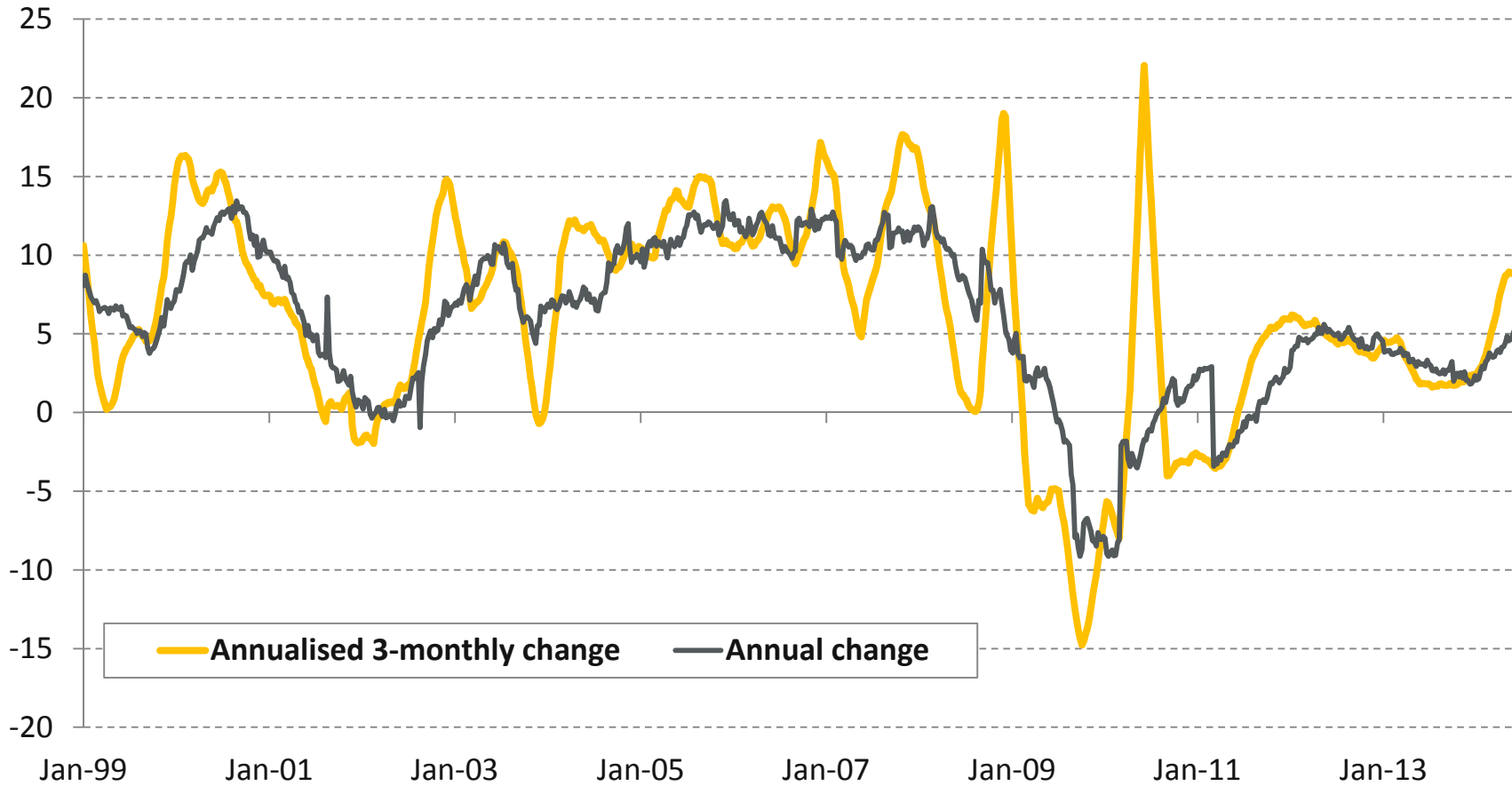


Inflation expectations remain modest

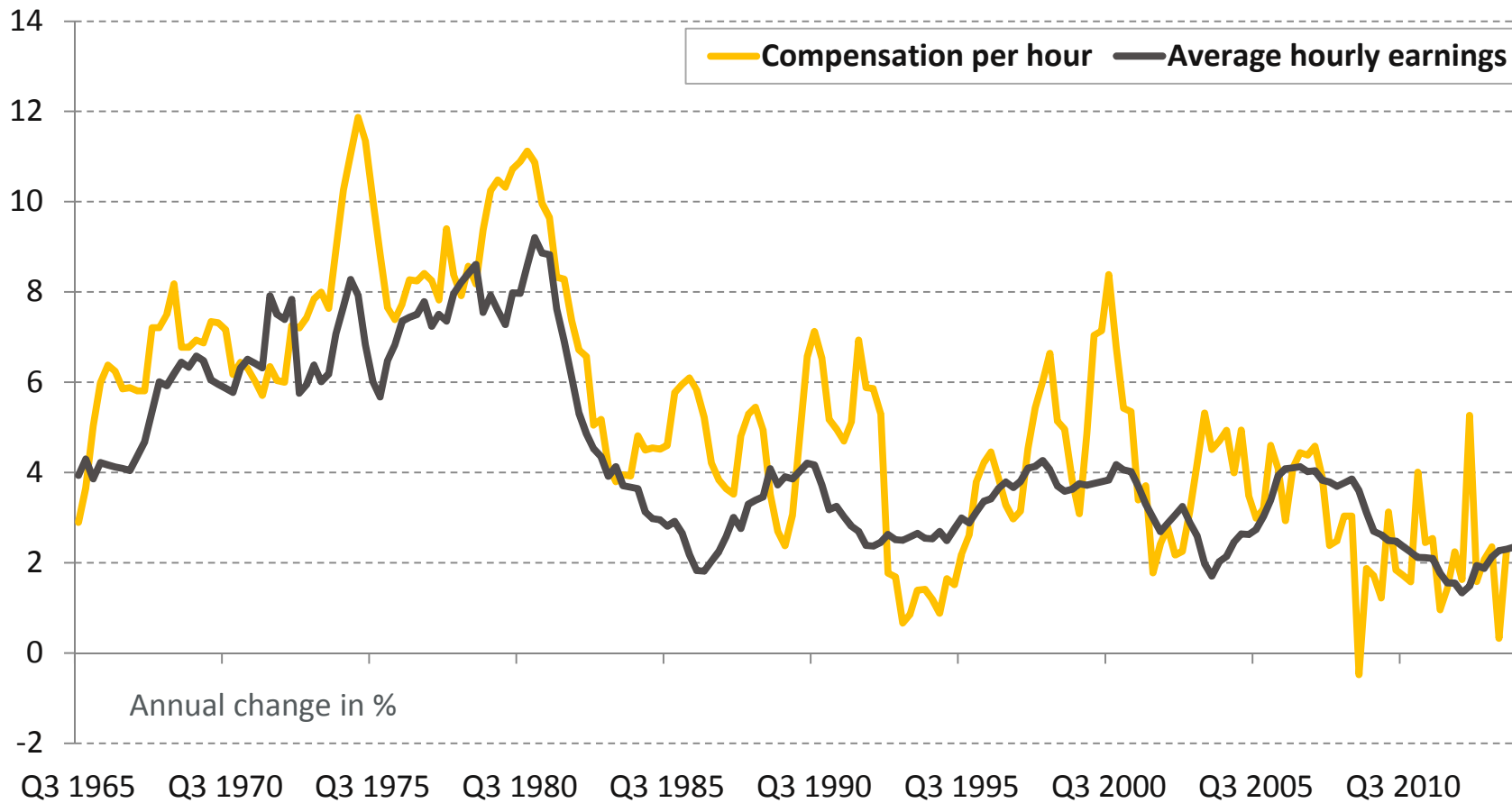


Credit growth is picking up

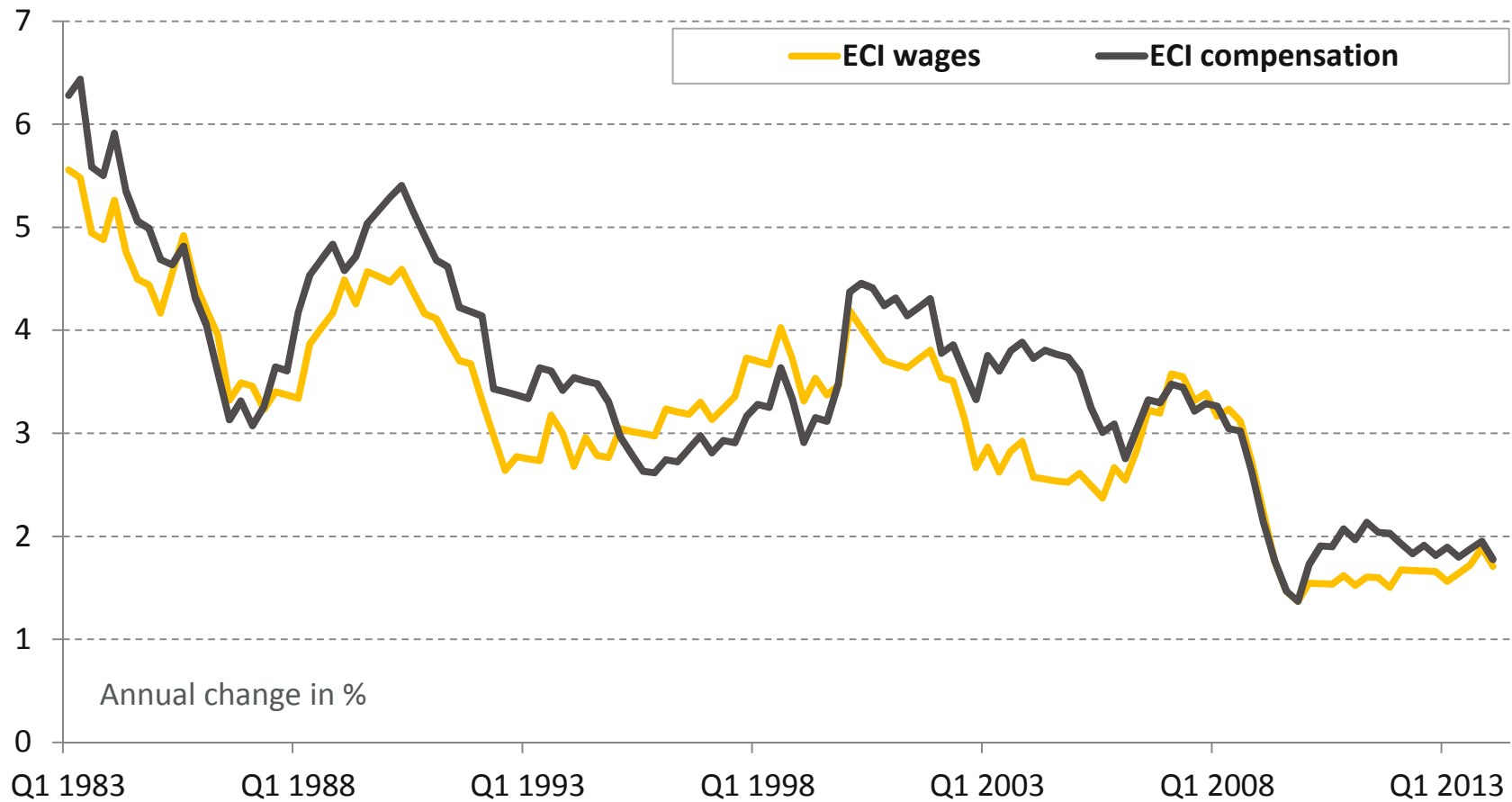
Loans&leases by US commercial banks



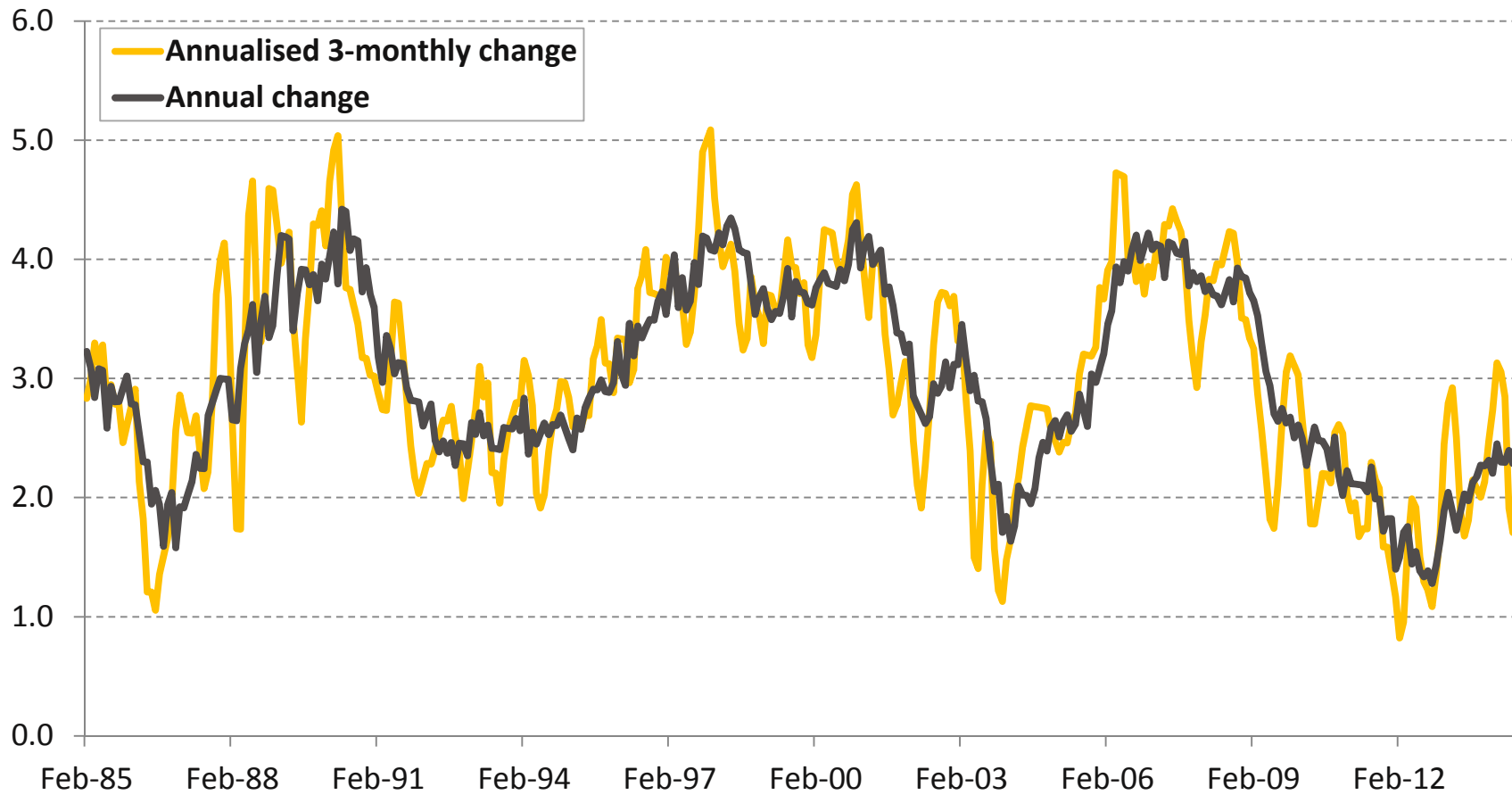
Wage growth remains subdued



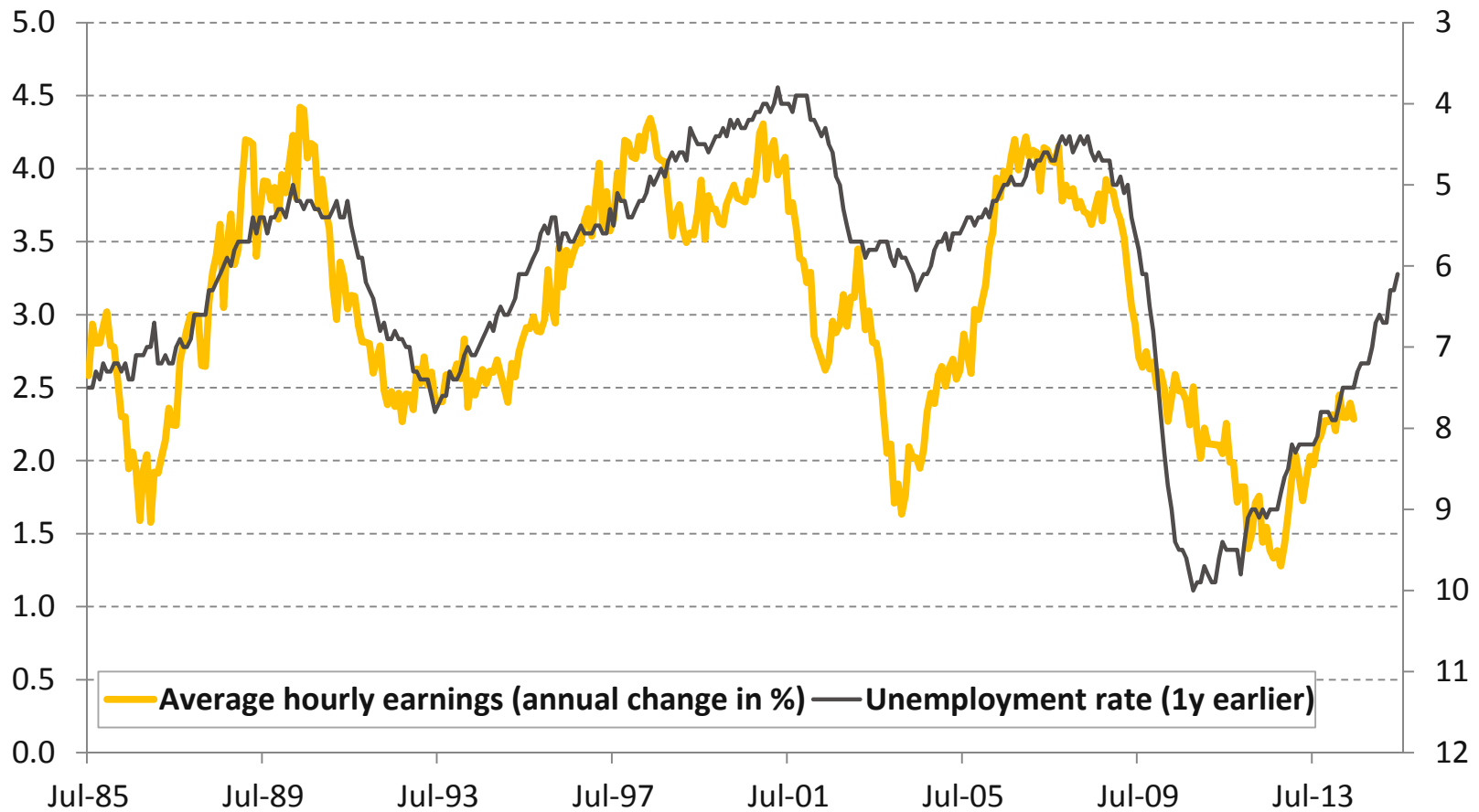
Wage growth remains subdued



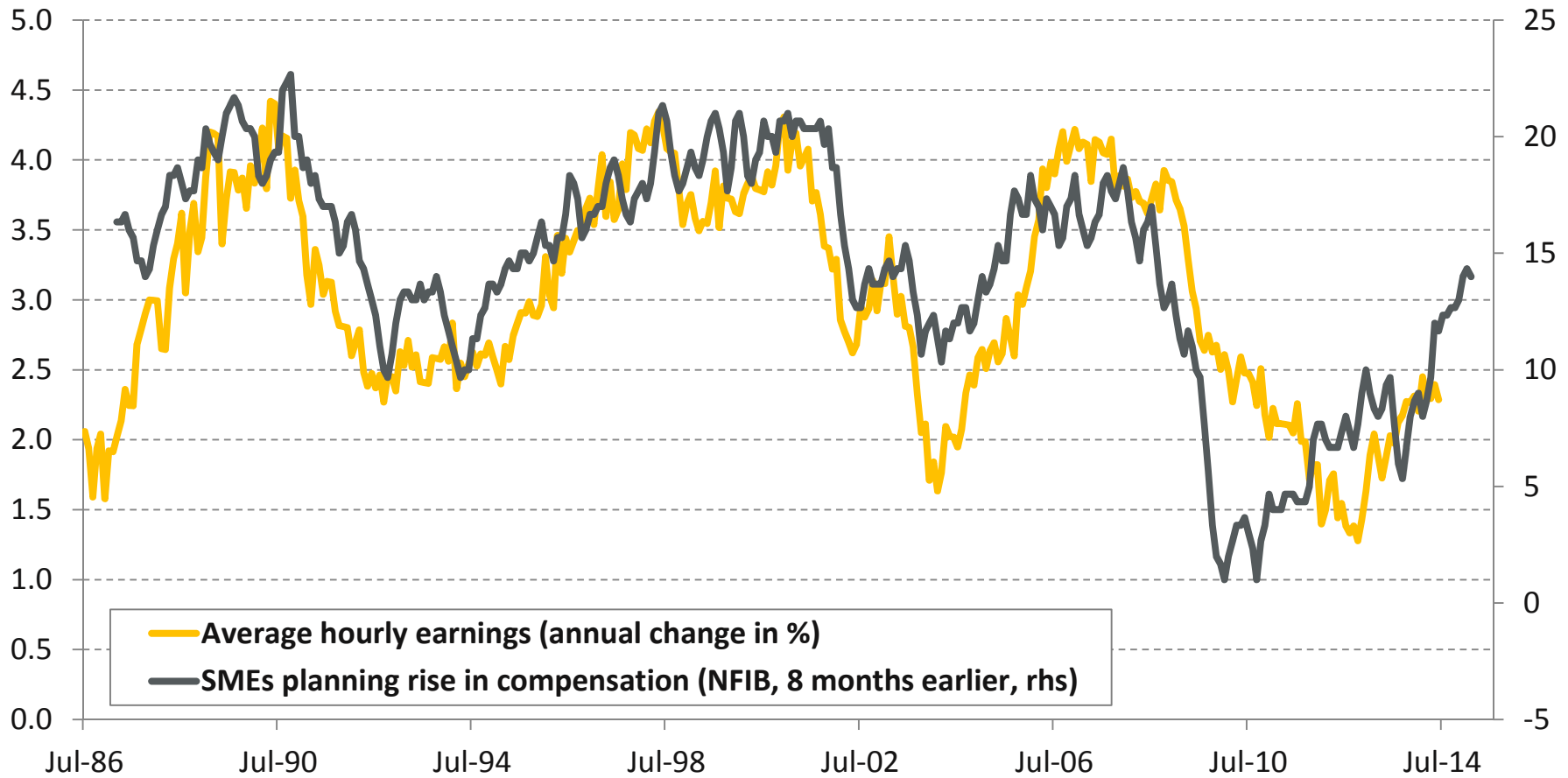
Average hourly earnings



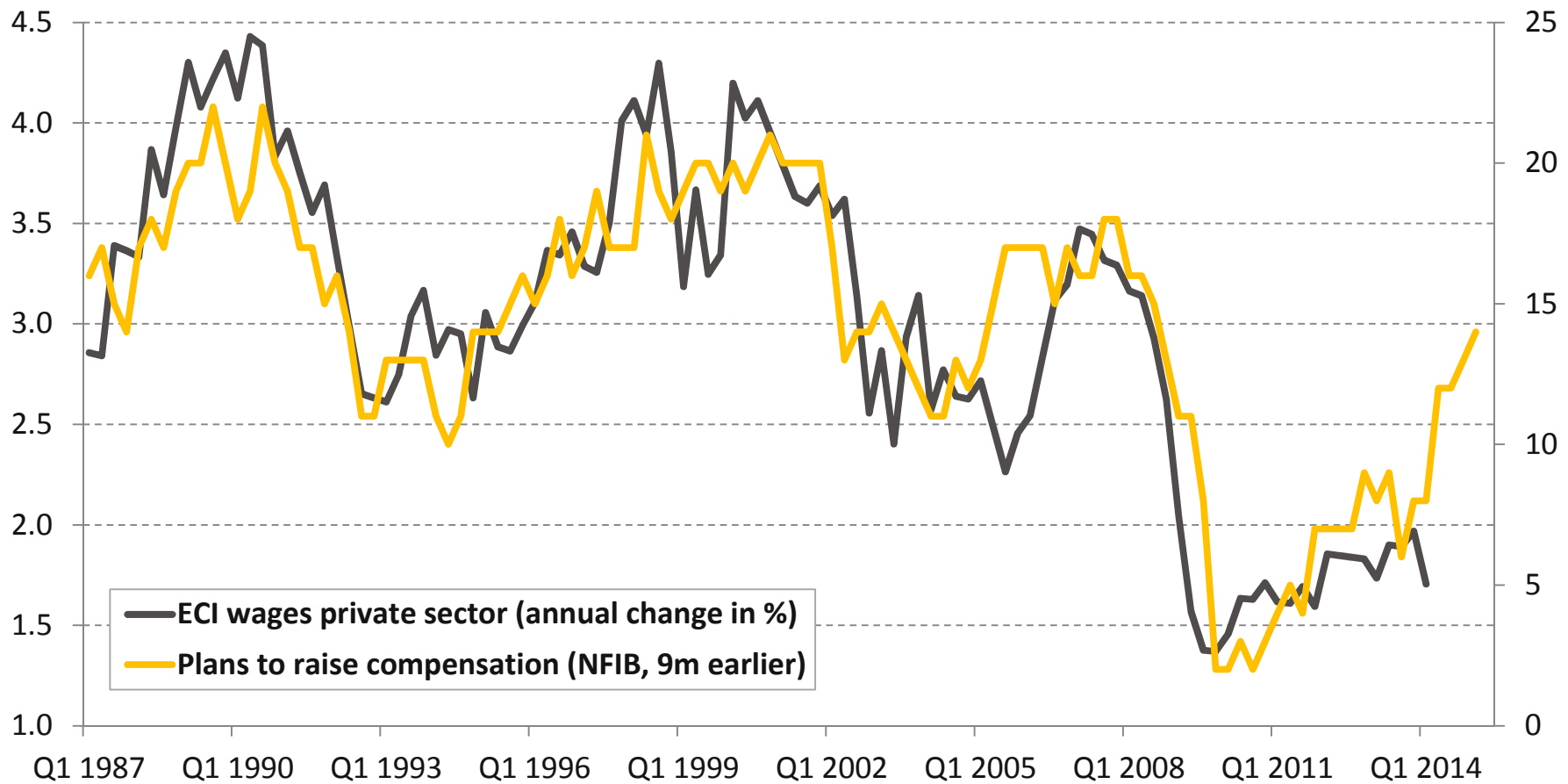
Falling unemployment will push up wage growth



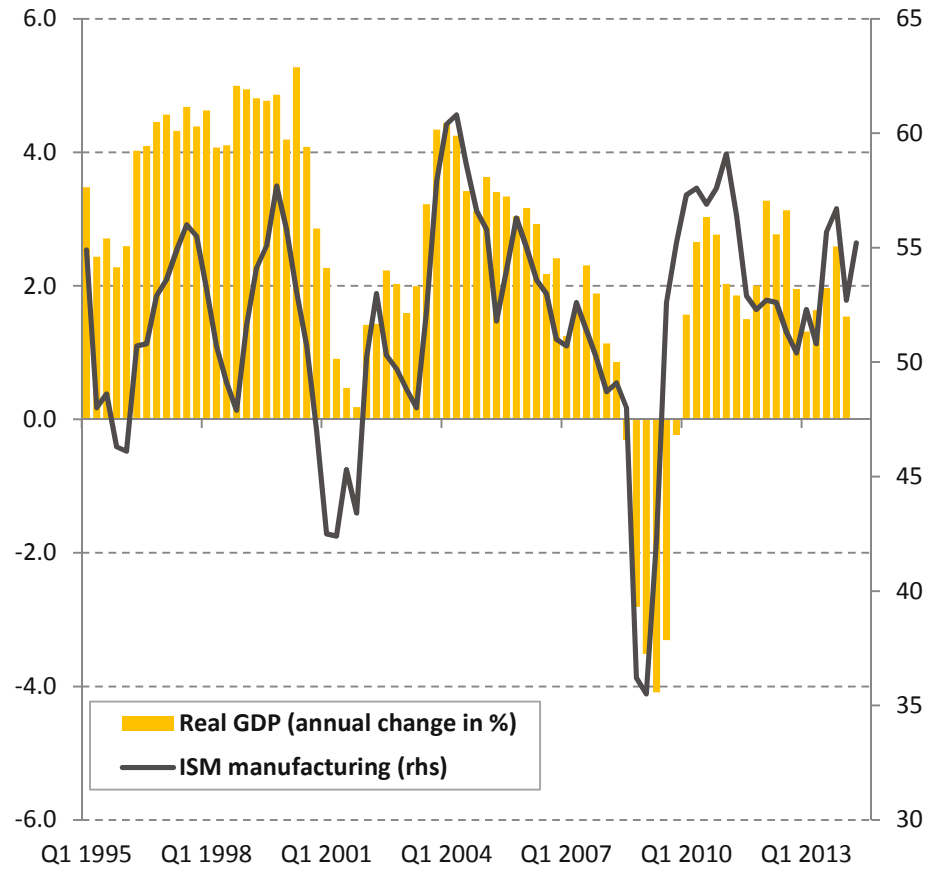
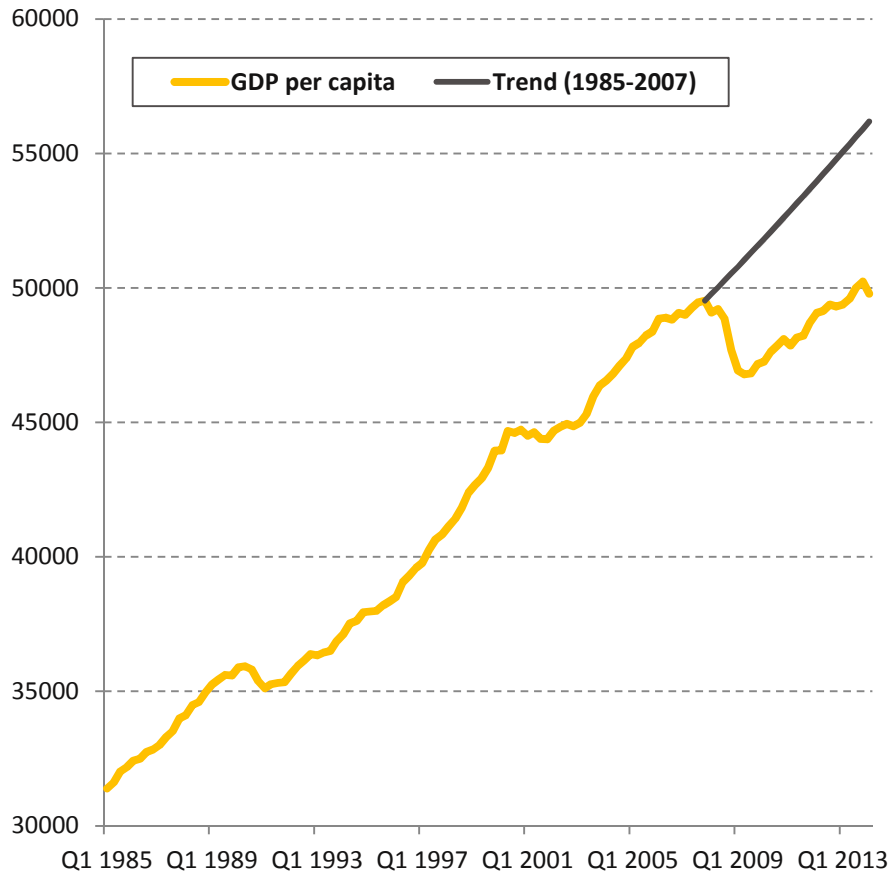
SMEs are raising compensation



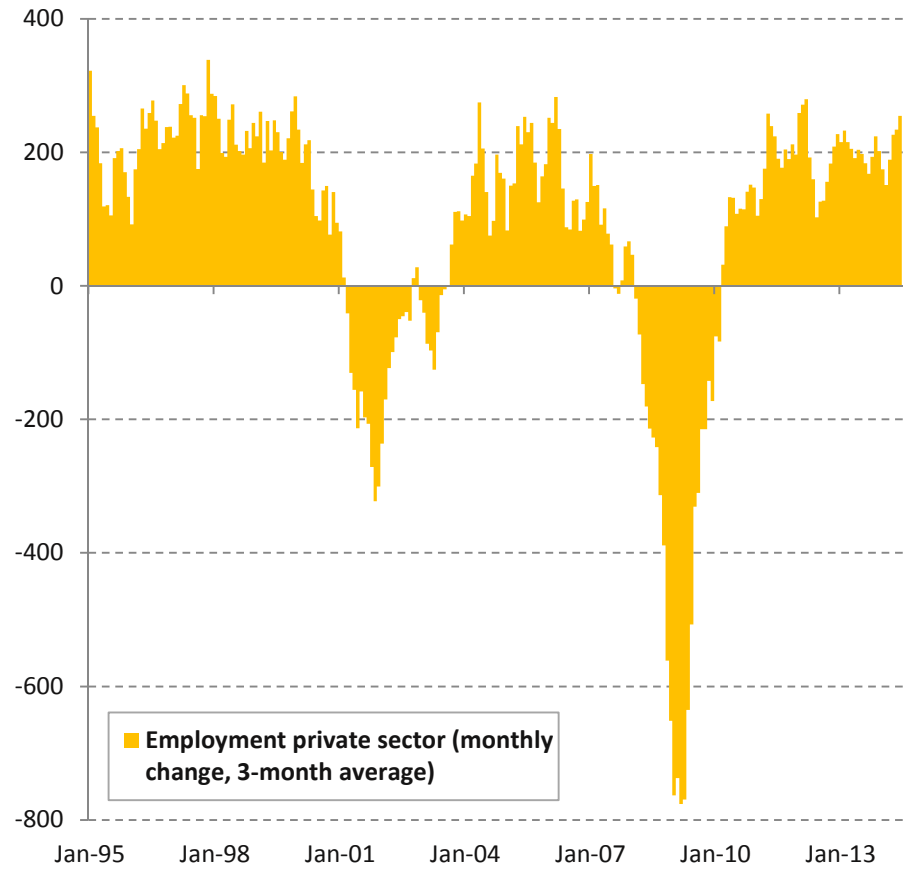
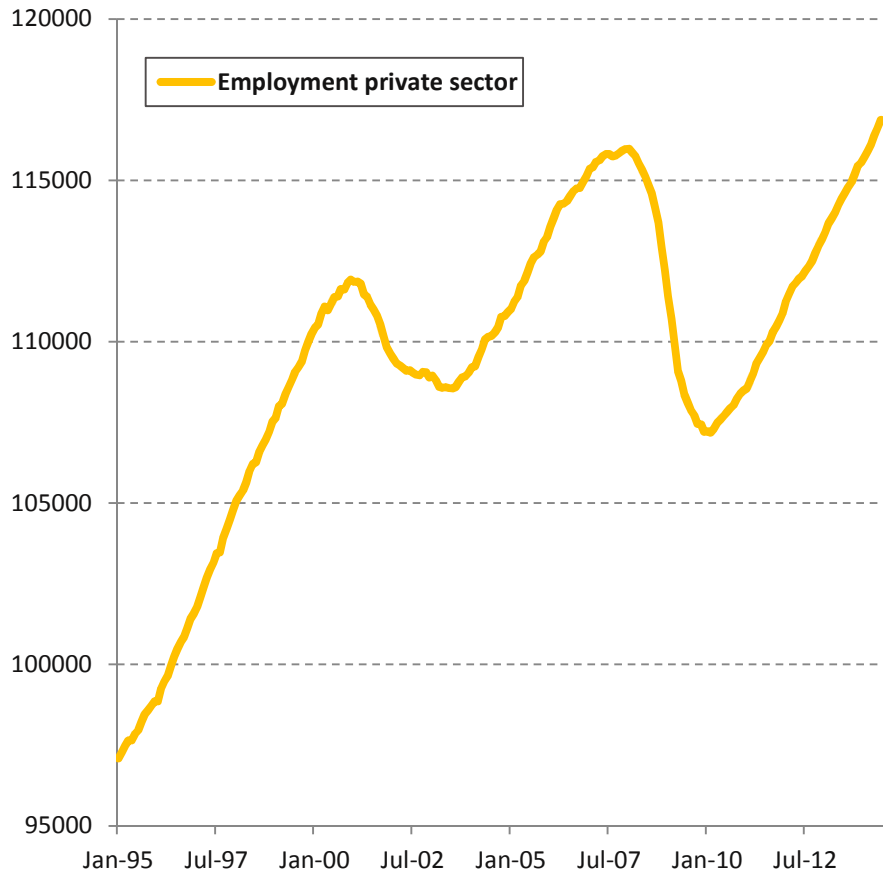
Wage growth set to accelerate



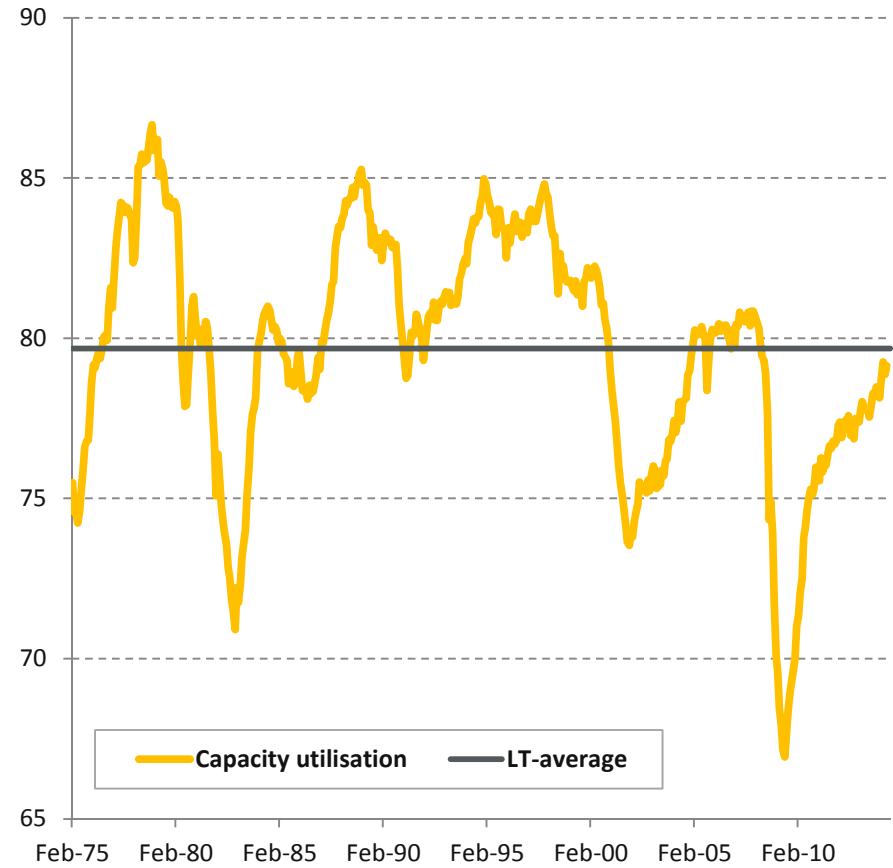
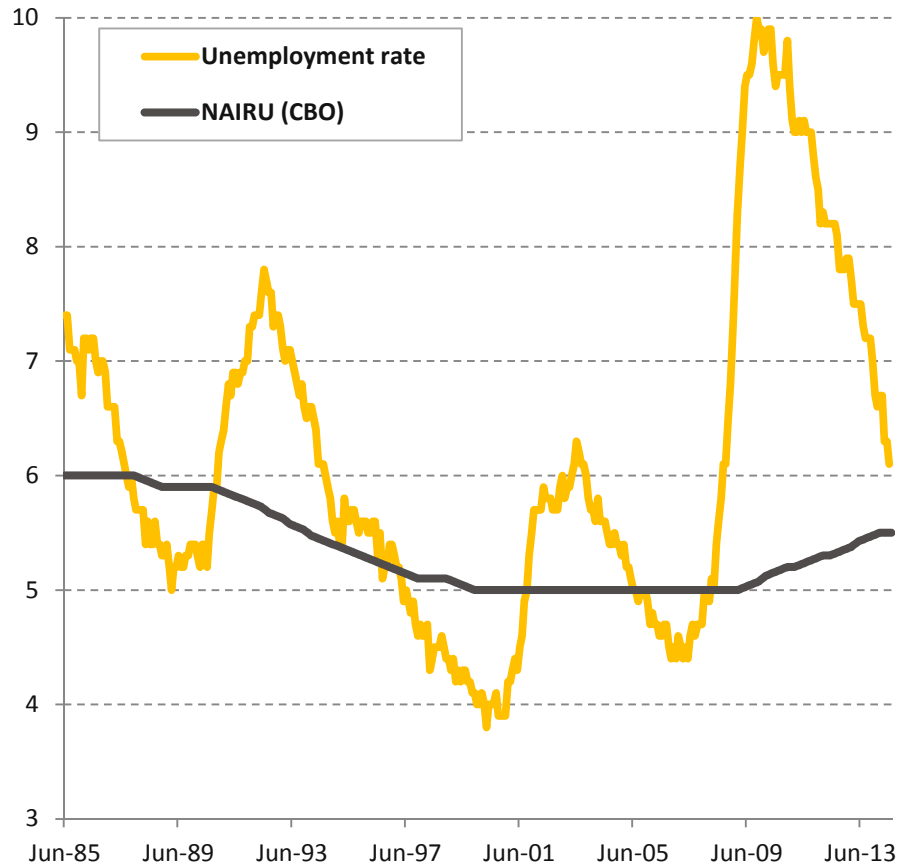
US economy is growing, but still far below precrisis trend



Decent job creation, but still making up for lost years

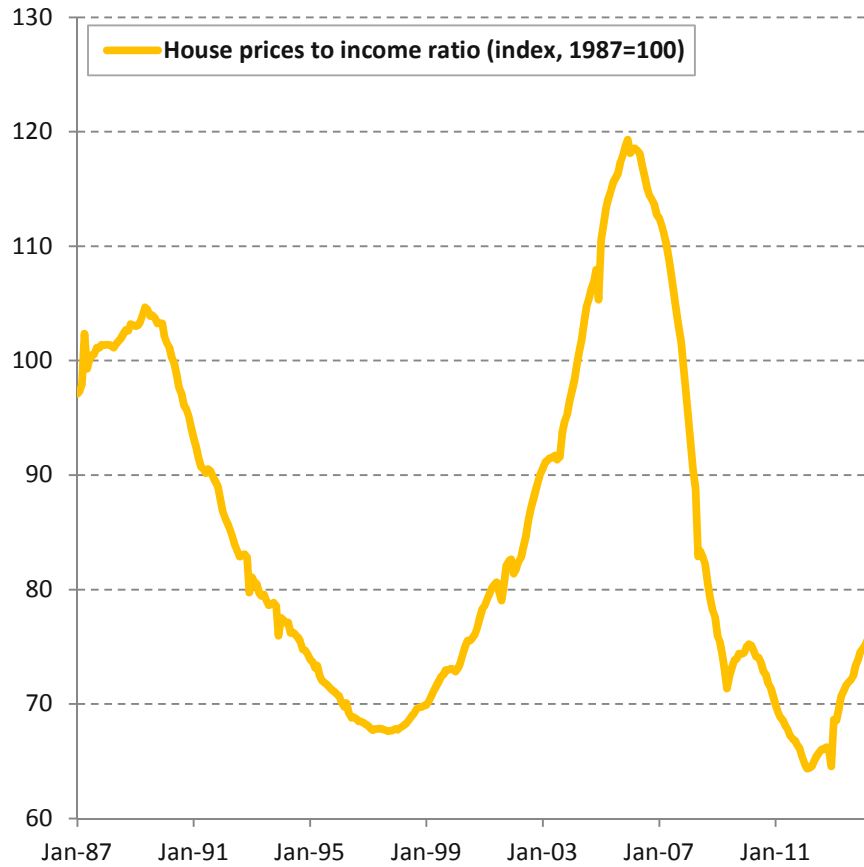


Declining slack in the economy

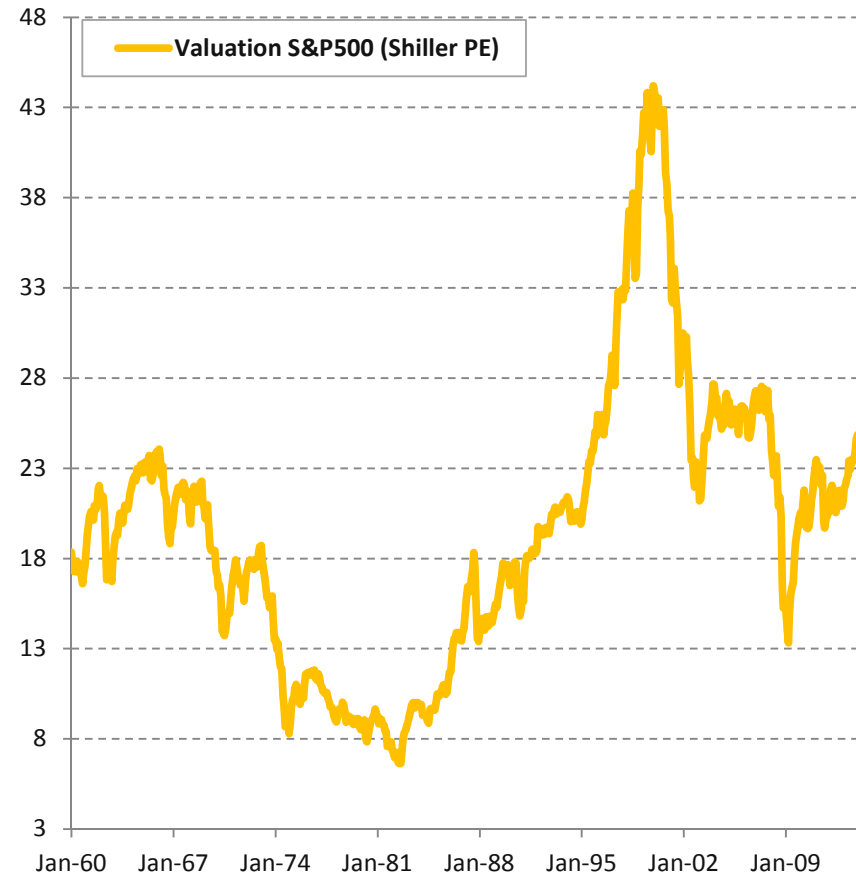


Always blowing bubbles?

US real estate



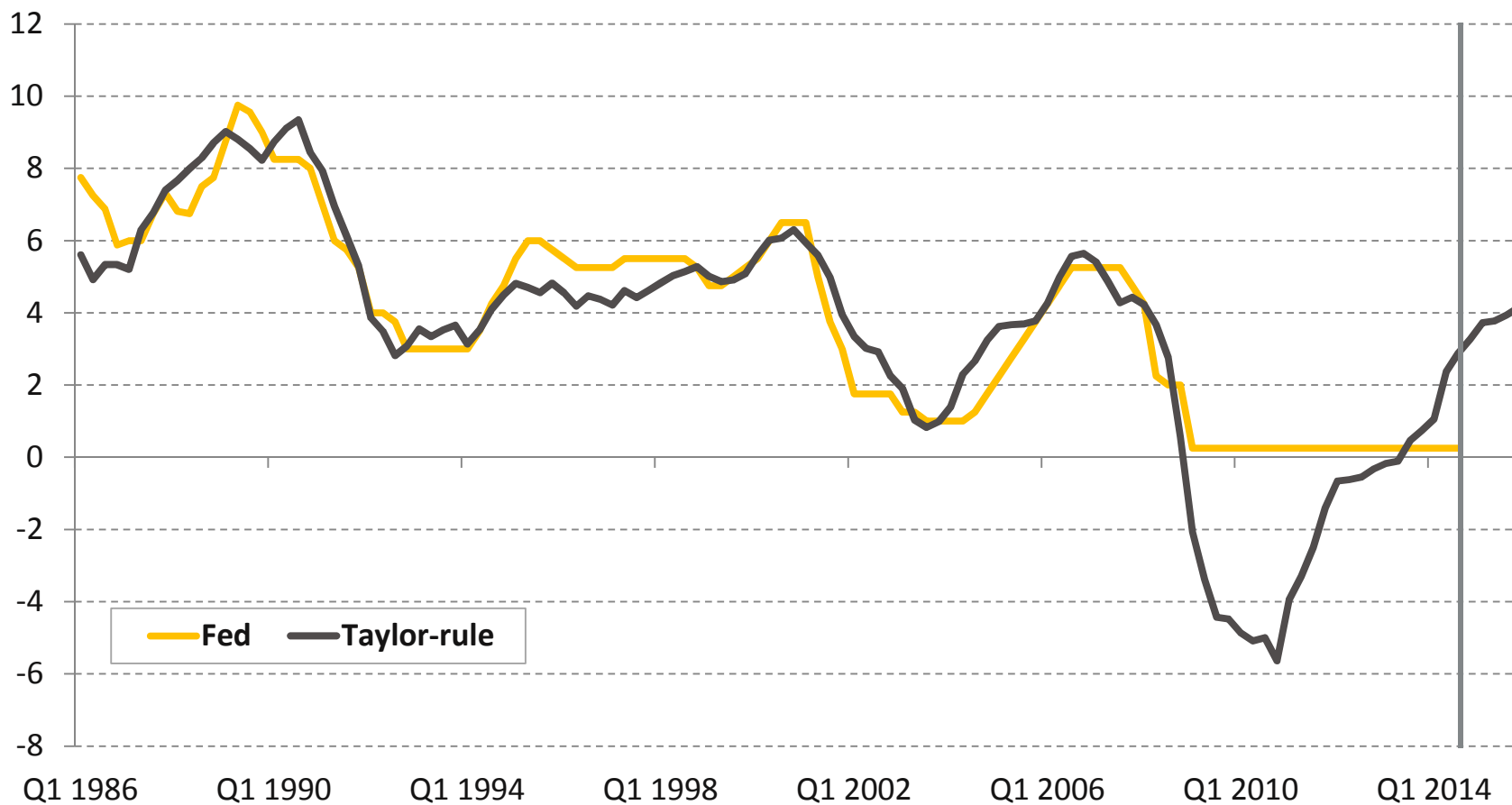
US equities



Issues for the Fed

- Inflation getting back to the target
- Wage growth leading indicators suggest significant acceleration
- Credit growth finally picking up
- Economic activity promising outlook, but still far below precrisis trend
- Slack in the economy decreasing rapidly
- Bubbles several asset classes are looking quite expensive

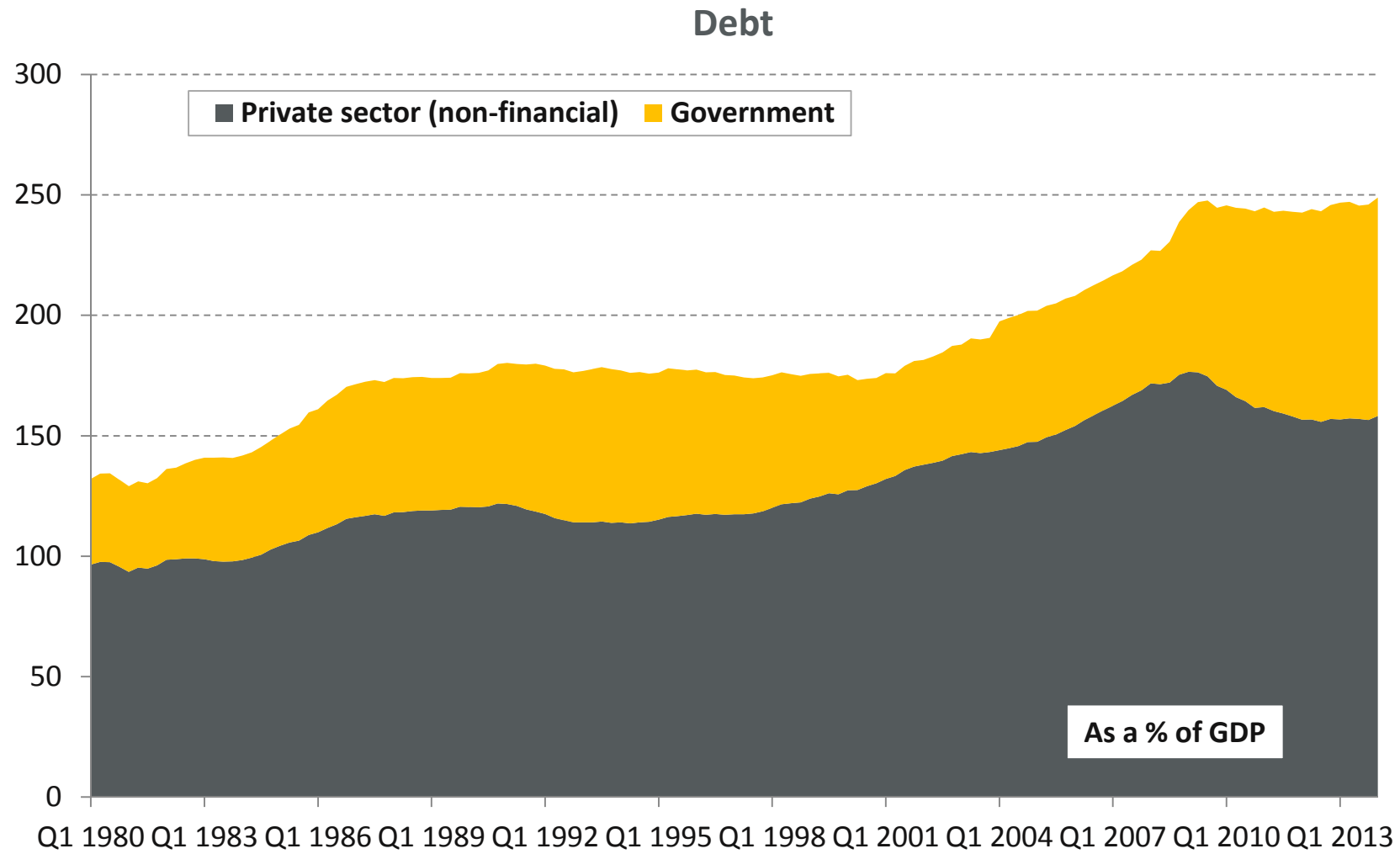
Basic Taylor-rule implies significantly higher interest rates



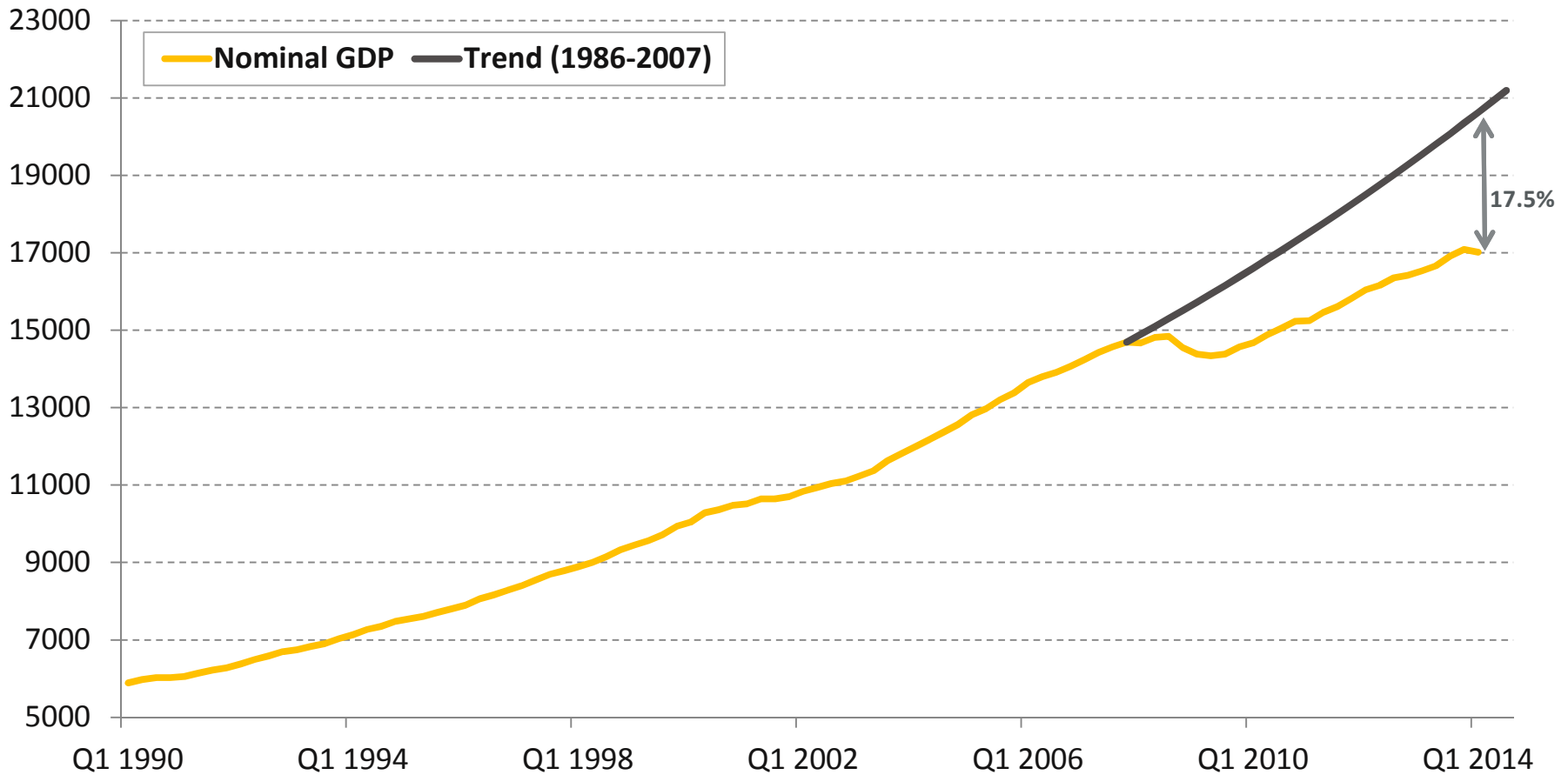
Reasons for the Fed to delay tightening

- Elevated debt levels
- Economy still far below precrisis trend
- Low employment rate

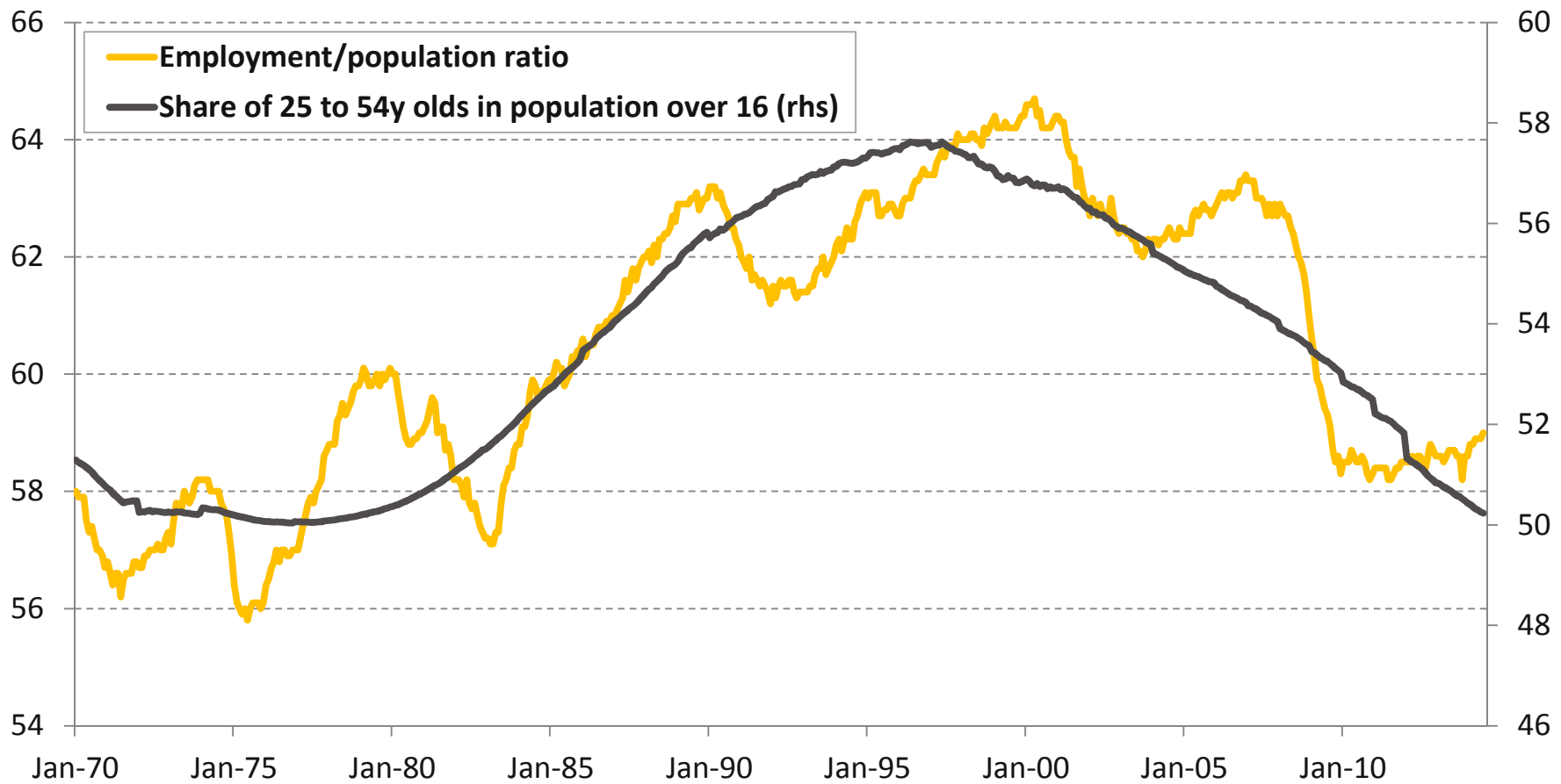
Elevated debt levels



Economy still far below precrisis trend



Low employment rate (even though part of this is structural)

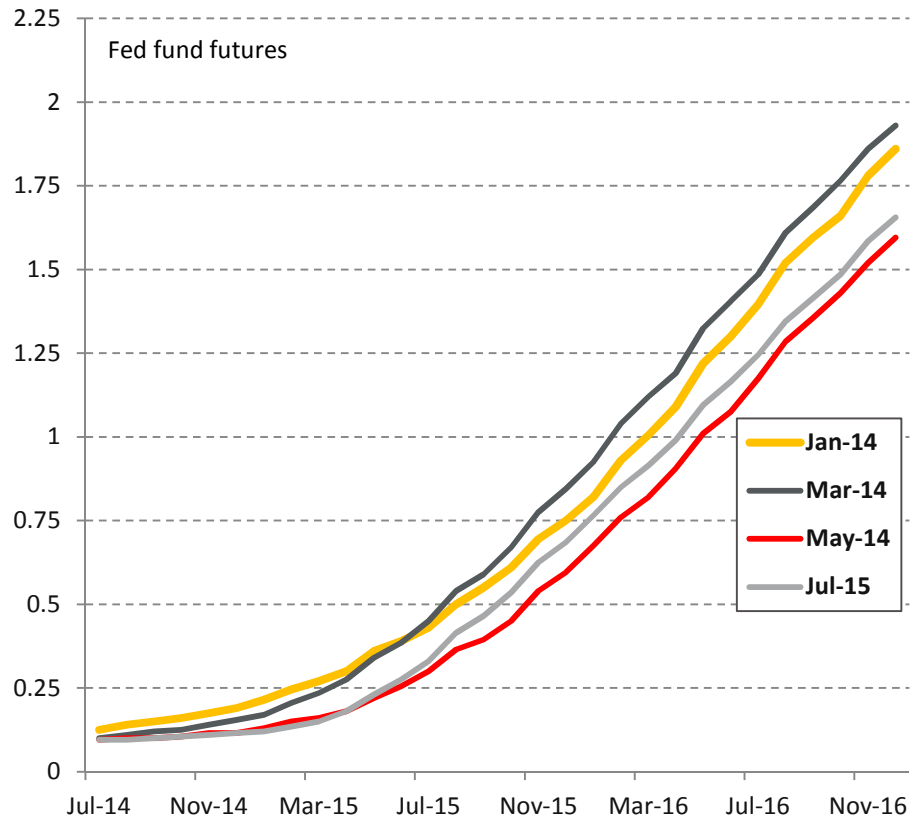


Outlook for the Fed

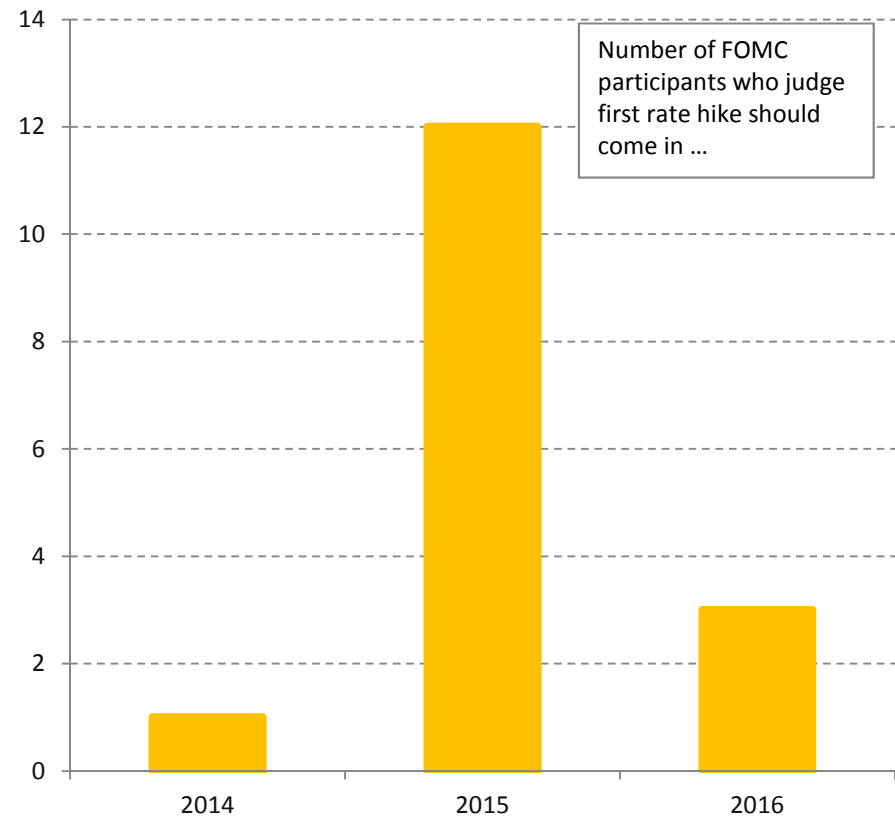
- QE to end in October
- Continue to reinvest the returns on its holdings well beyond the first rate hike (i.e. keeping the balance sheet stable)
- First rate hike is expected for Q2 2015
- Gradual hiking cycle: slower than usual
- The Fed will try to limit upward pressure on longer term interest rates through its forward guidance

Expectations for the Fed policy rate

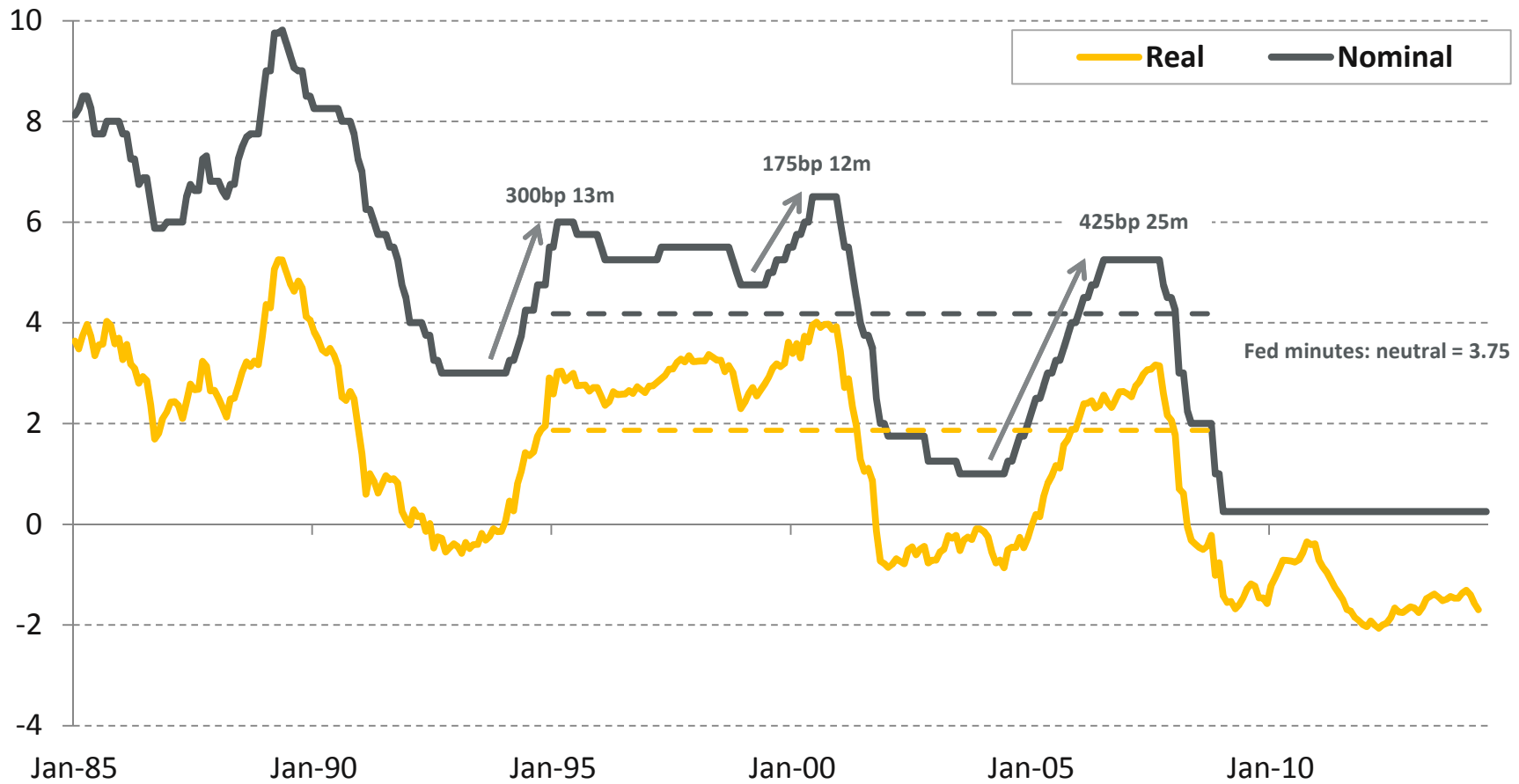
Market



Fed

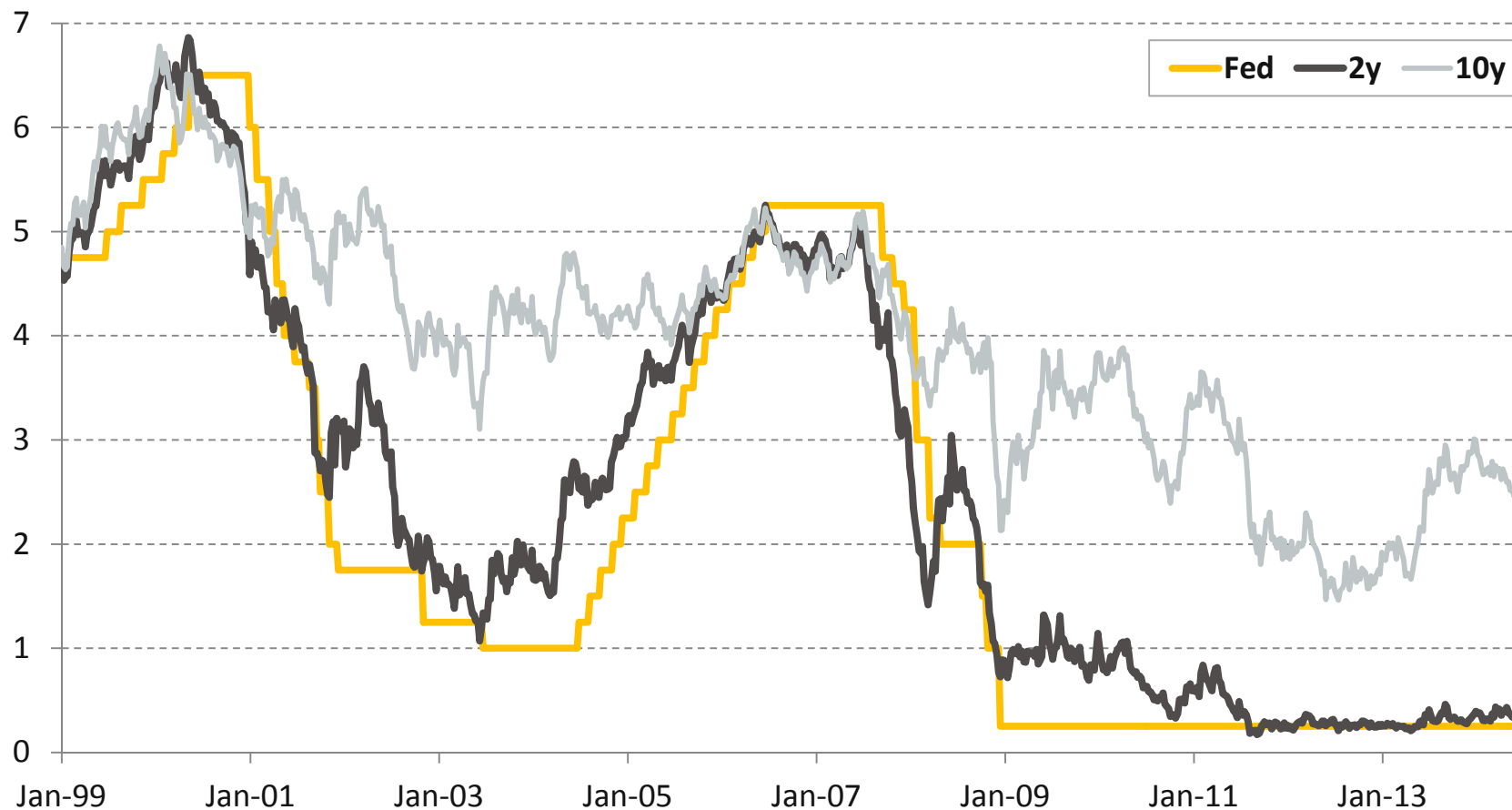


Fed policy rate



Current futures: fed funds at 2.1 by June 2017 (200bp in 26m)

Interest rates: markets still relaxed on possible rate hikes

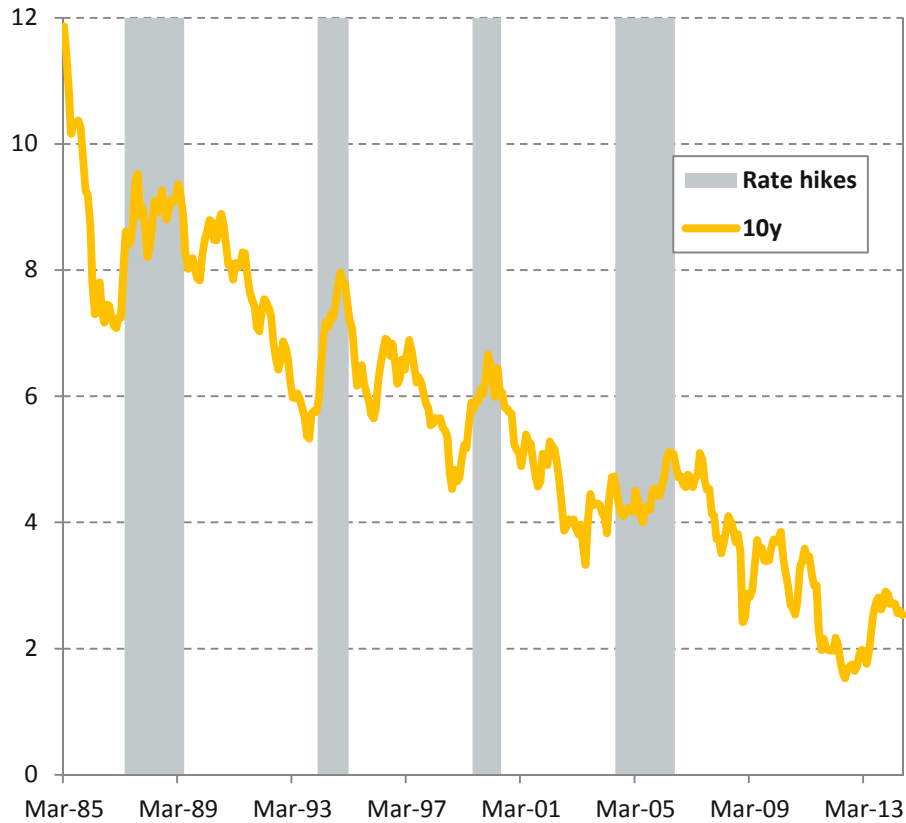


Outlook for the Fed

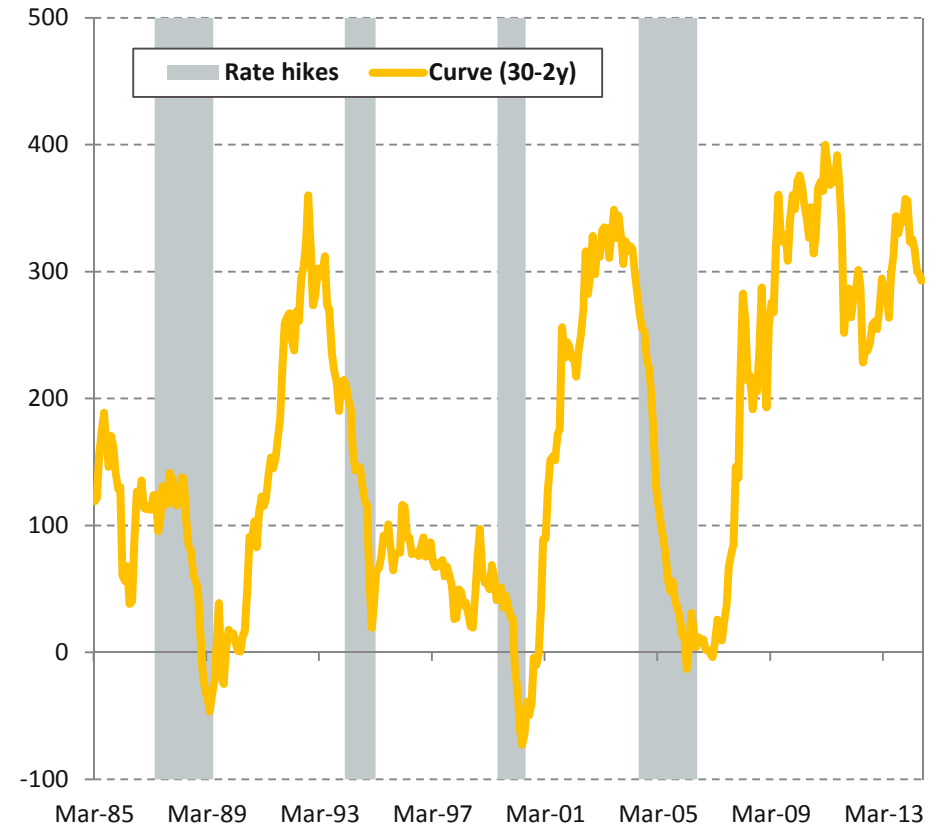
- Increasing signs that monetary stimulus is having effect
- Crisis legacy continues to hold back the Fed
- For now Fed remains fully focused on growth (and this is likely to remain the case for quite some time)
- The Fed is willing to allow somewhat higher inflation and remains fairly relaxed on risk of financial excess
- Heading towards first rate hike in Spring 2015

Impact of US rate hikes on bond markets

10y



Curve (30-2y)



Outlook for the Fed: rate hiking cycle

- Likely to be slower than usual, but faster than markets currently expect
- Interest rates move up along the curve
- Curve flattening
- Positive for the dollar
- In the past, initial phase of hiking cycle still positive for equity markets



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