HERMES INVESTMENT MANAGEMENT

OUTCOMES BEYOND PERFORMANCE

1 September 2017

Economic outlook

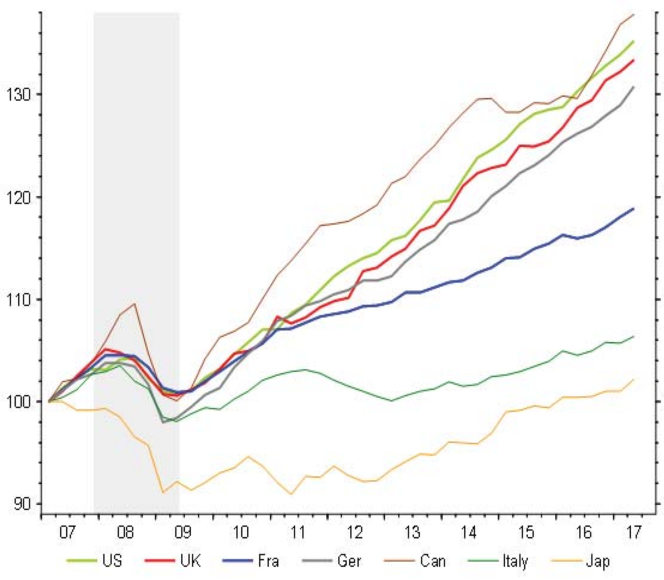
Neil Williams, Group Chief Economist
+44 (0) 20 7680 2398

Not tight, just less loose...

Main points

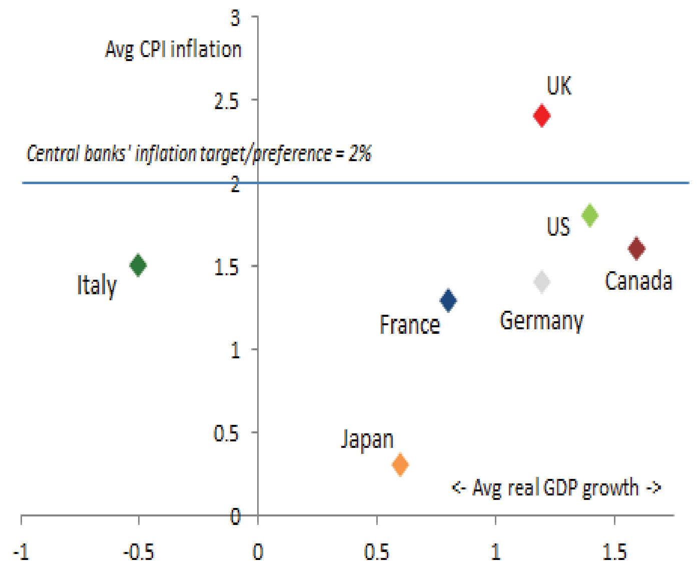
- Ten years after the first glimpse of crisis, & major economies have recouped their GDP. But, despite 'muscle flexing', the road to policy normalisation will be long & slow, with the prospect of another two years of negative real rates in the US, UK, Japan, & euro-zone.
- Our analysis suggests that by sustaining its QT programme, the US Fed could 'take out' as much as 130bp of further rate hikes by 2019. US rates, when they peak, should be far lower than we're used to.
- But, the frustration for all G7 central banks is that recoveries since 2009 have mainly been output driven. And, with output gaps slow to close & wage pressure still capped, they've yet to generate enough inflation to trigger central banks' usual reaction functions.
- The one main economy that has delivered inflation is the UK, which is doubtless a symptom of the pound's decline. Yet, the BoE looks loathe to raise rates during the Brexit process. While the CPI should stay above target, the inflationary flame may snuff itself out.
- The ECB, meanwhile, could taper its QE by 'natural causes' as some members' buying limits approach. It could fill the gap by buying proportionately more from others, but this may not be palatable to Germany as it questions Mr Macron's unified budget proposal.
- Japan still has every incentive to prolong a policy loosening now in its nineteenth year. It may be the last to end QE. While, in China, even if President Xi addresses asset-price bubbles, rising corporate debt, & shadow banking, its policy tightening should be limited.
- The more serious risk is US trade tariffs, where Mr Trump could still invoke 'Super 301'. And, linked to that, it remains to be seen how more combative US/China relations become over N. Korea.
- So, all in, this gives credence to the 'new normal' view of low-for-longer rates, rather than an imminent return to pre-crisis levels. In which case, the most we might expect even in 2019 is not for policy to become tight again by traditional standards, just less loose...

Chart 1. Major economies have recouped their nominal GDP...
Nominal GDP re-based to Q1 2007 (= 100). Grey denotes US recession



Source: Thomson Reuters Datastream, based on national data

Chart 2. But, these are output recoveries that have not generated inflation
Real GDP growth & CPI inflation rates since 2007. Averages, both %yoy



Source: Hermes Investment Management, based on national data

Comment

Ten years after the first glimpse of the financial crisis, and major economies have finally recouped their GDP *(chart 1)*. Even Japan, whose deflationary crisis originated two decades earlier, and Italy, hamstrung by the euro, are back to 'square one'. Arguably, most of the macro effects from the crisis were not registered till 2008, which then triggered a round of monetary stimulus - conventional and unorthodox - unparalleled since the 1930s. So, with recoveries now maturing, unemployment rates lower, and asset prices bloated by eight years of cheap money, central bankers (*e.g.* at June's ECB Forum in Sintra) are increasingly striking a more hawkish tone.

Output recoveries since 2009 have yet to generate the inflation central banks crave

But, despite 'muscle flexing', the road to policy normalisation is likely to be long and slow, with the prospect of another two years of negative real policy rates in the US, UK, Japan, and euro-zone. For the US and UK, this is on top of the nine we've had. The US is leading, where the Fed is about to become the test case for how to push both monetary levers: gradual rate hikes and balance-sheet correction. It has lifted its policy rate four times since 2015 (slow for a cycle), accompanied in the G7 only by one hike this year in closely-aligned Canada.

Our analysis on ***page 3*** suggests that, by sustaining its proposed 'non re-investment' (QT) programme, the Fed could 'take out' as much as 130bp of further rate hikes by 2019. But, unless it's accelerated, it would take till 2023 before the balance sheet is taken back to the $1trn considered 'normal'. The verifies chair Yellen's warning that it'll be like *"watching paint dry"*. ***Chart 3*** shows just how loose US policy will remain, when its real rates are adjusted for changes to the QE stock.

It suggests US rates, when they peak, will be far lower than we're used to. The FOMC has from 2009 talked up the efficacy of QE, yet kept silent on the down-side risks from QT. **This suggests their dot-plot peak rate of 3% may not fully take into account its planned QT. In which case, the true peak Fed funds rate may be closer to our 1½%, when you take off the estimated rate-saving (130bp) from non re-investment.**

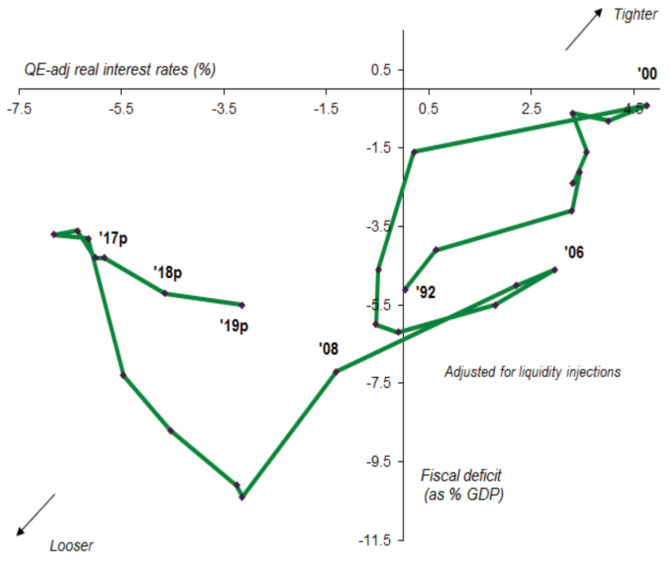
The background frustration for G7 central banks in general is shown in ***chart 2***, which breaks down these nominal GDP recoveries into their real output and inflation components. Recoveries since 2009 have largely been output driven. **And, with output gaps slow to close and wage pressure capped by low productivity and (US aside) rising labour participation rates, they've yet to generate enough inflation to trigger central banks' usual reaction functions.**

The one main economy that has delivered inflation is the UK, which is doubtless a symptom of the pound's 30% trade-weighted fall since 2007. Only Italy's GDP/CPI trade-off has been worse. Yet, the BoE now looks loathe to raise rates during the Brexit process ***(page 6)***. Any policy correction here is likely to come from the fiscal side. Should the pound plummet and/or protectionism build, inflation will reappear, with our simulations showing the CPI staying above its +2%yoy target. **But, it'll be the 'wrong sort' – cost-push, rather than 'feel-good' demand-pull. In which case, the inflationary flame may snuff itself out.**

At the ECB, Mr Draghi is declaring *"deflation risks have definitely gone away"*, but that we need to be *"patient on inflation"*. (ECB press conference, 8 June). Markets now await detail on QE tapering in 2018, after last April's initial cut, from €80bn asset purchases per month to €60bn. But, even this extra €540bn from April to year-end is more than twice the cumulative GDPs of Greece and Portugal. With buying limits being approached in Germany (its Capital Key prohibits the ECB holding more than one-third of German debt), the ECB could taper by

Chart 3. Meaning a long road back to 'normal'. US rates - hawkish case

QE & QT-adj Fed funds rate, core PCE, & cyc-adj fiscal balance. ***FOMC's rate view***



Source: Hermes Investment Management, based on OECD, FOMC, & Bloomberg data

'natural causes' in 2018. Alternatively, they could fill the gap by buying proportionately more from countries (e.g. France/Italy) whose limits are more remote. **But, this may not be palatable to Germany, as it pushes back on Mr Macron's unified budget proposal *(page 5)*.**

In Japan, PM Abe still has every incentive to prolong a policy loosening now in its nineteenth year *(page 4)*. The MoF hopes that, by maintaining nominal growth above the average long-term interest rate, it can carry on borrowing without raising the debt ratio. But, this catch-22 precludes the BoJ from switching off, or even reducing, its QE. This leaves some officials believing the BoJ will be the last central bank to ever stop QE, and even eulogising the MoF/BoJ's debt symbiosis.

In China ***(page 7)***, the policy landscape may look different after the Politburo reshuffle this autumn. With President Xi's hand strengthened, he could focus more on asset-price bubbles, rising corporate debt, and shadow banking. Yet, with growth needing to average 6½%yoy to double 2010's GDP level by 2020, policy tightening should be limited.

The more serious risk is US trade tariffs. In 1930, they were triggered by the Smoot-Hawley reforms that raised US tariffs to up to 20% on over 20,000 imported goods. Congress this time may push back on a general approach. Yet, Mr Trump could still invoke 'Super 301' to impose tariffs without its or WTO approval. In which case, without care, an unhelpful jigsaw piece from the 1930s - retaliatory trade protectionism - might yet come crashing into place.

And, linked to that, it remains to be seen how more combative US/China relations become over N. Korea. Retaliation by China to any US protectionism could be sought by *inter alia* a large renminbi devaluation, which in turn risks imploding China's corporate and banks' balance sheets. Hopefully, China's sizeable US Treasury holdings for one (about 15% of total) provide a mutual deterrent.

So, all in, this gives credence to the 'new normal' view of low-for-longer rates, rather than an imminent 'normalisation' to pre-crisis levels. In which case, the most we might expect even in 2019 is not for policy to become tight by traditional standards, just less loose.

United States

The FOMC are proposing a gradual erosion of QE, by starting to phase out the US Fed's Treasury and MBS reinvestments *"relatively soon"* (July Statement). It is the logical next tightening step, but the gentlest possible form of QT. Asset sales would be deferred, but their replacement-rate on the balance sheet tapered increasingly every three months. FOMC member John Williams suggests *"...something like five years"* before the $4½trn balance sheet returns to a more normal ($1trn) size. This is optimistic, but achievable.

By sustaining QT, the Fed could take out as much as 130bp in rate hikes by 2019...

The FOMC could announce this at their 20 September meeting, with the first 'non re-investments' in October. What they have in mind is to *"...announce a set of gradually increasing caps...on the securities that would be allowed to run off each month, and only the amounts of repayments that exceeded the caps...reinvested. These caps would initially be set at low levels and then be raised every three months... until the balance sheet was normalised"* (FOMC's May Minutes). FOMC staff are proposing an initial $10bn monthly 'roll off' ($6bn Treasuries, $4bn MBS), rising in $10bn increments to $50bn, before it is reviewed.

To quantify the impact on rates and gauge how the overall, monetary and fiscal, policy position should shift to 2019, we update our *'Policy Looseness Analysis'*. By taking explicit account of the past eight years of QE, proposed QT, and also fiscal positions, our analysis beefs up the 'Taylor Rule' the Fed traditionally uses for setting rates. The Rule (without QE and fiscal considerations) currently pitches the Fed's target rate at 4.75% (close to its long-term average). **At 350bp over the Fed's current 1.00-1.25% range, those FOMC members targeting an unusually low peak rate are, helpfully, ignoring their own Rule.**

***Charts 3 and 4* summarise the results.** In each, we quantify the impact of QE on rates by adjusting real rates for former Fed chairman, Bernanke's assertion that the $600bn part of QE2 back in 2011 was equivalent to slicing an extra 75bp off the Fed funds target. See our *Tightening by doing nothing* report (May 2017) for more. **This has led to a *de facto* (QE-adjusted) *nominal* Fed funds rate now of about -4%: much lower than the 1¼% 'official' rate.** This equates to a near -6% *real* rate when we adjust with the Fed's +2%yoy core PCE target.

Economic & interest rate projections (p)

% yoy unless stated	'12	'13	'14	'15	'16	'17p	'18p
Real GDP	2.2	1.7	2.6	2.9	1.5	2.0	1.8
Personal consumption	1.5	1.5	2.9	3.6	2.7	2.6	2.2
Business investment	9.0	3.5	6.9	2.3	-0.6	3.5	2.2
Industrial production	2.8	2.0	3.1	-0.7	-1.2	1.8	2.0
Consumer prices (nsa)	2.1	1.5	1.6	0.1	1.3	2.0	2.2
Unemployment rate (%)	8.1	7.4	6.2	5.3	4.8	4.4	4.3
Current account (% GDP)	-2.6	-2.1	-2.1	-2.4	-2.4	-2.7	-2.8
Fed budget balance (% GDP)	-6.5	-3.3	-2.8	-2.6	-3.1	-3.3	-3.5
Funds target (yr-end, %)	0.25	0.25	0.25	0.50	0.75	1.50	1.50

Source: National data, Hermes Investment Management, OECD, & Consensus Economics

Chart 4. The Fed's potential 'non re-investment' programme

FOMC staff's proposed scheme for non re-investment of the Fed's maturing securities

QT 2017-19 — **$4,500bn** = total balance sheet

	Potential non re-investment ($bn per quarter)		***Equivalent rate hike** (Full year, bp, rounded)
2017 Q4	30	= 3x $10bn p/m	5
2018 Q1	60	= 3x $20bn p/m	
2018 Q2	90	= 3x $30bn p/m	
2018 Q3	120	= 3x $40bn p/m	
2018 Q4	150	= 3x $50bn p/m	50
2019 Q1	150	= 3x $50bn p/m	
2019 Q2	150	"	
2019 Q3	150	"	
2019 Q4	150	"	75
Total =	**1,050**		**130**

Source: Hermes Investment Management*, FOMC June Statement, & *Addendum*

On this basis, our analysis offers the following observations.

First, assuming symmetry for QT (that is, a hypothetical $600bn of QT would be equivalent to an around 75bp *on* the Fed funds rate *etc*), the Fed could by sustaining its programme 'take out' as much as 130bp of further rate hikes by 2019. *Chart 4* is based on the Fed starting QT in October, and maintaining the $50bn per-month pace after its review.

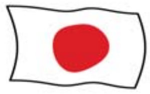
To put into perspective, the possible cumulative $1.1trn of QT by 2019 would be significant (5% of US GDP), representing about a quarter of the current balance sheet, or approaching a third of 'excess reserves' (i.e. the around $3½trn accumulated since the global crisis). **But, unless the pace of QT is accelerated further, it would on this basis take till 2023 before it's taken back to the $1trn considered 'normal'.**

Second, given the assumed trade-offs, the process of interest-rate normalisation will also be slow. *Chart 3* is mapped on the basis described above, proxying both monetary and shifts. To test the extreme case, we use the FOMC's relatively hawkish 'dot-plot', which has long signalled 2¼% by the end of 2018, *en route* to a 3% peak rate by 2019. Yet, even the cumulative $1.1trn QT leaves the *de facto*, QT-adjusted, real funds rate in negative territory in 2019, at about -3%. And there's unlikely to be a compensating shift in the fiscal stance.

More likely, the use of QT to do some of the heavy lifting, the lagged effect of the previous four 25bp hikes (an average 18 months before rate hikes fully affect consumer spending), deferred tax cuts, tame core inflation, and possible protectionism, could mean a much lower peak rate, which we expect to be about 1½%. In which case, the QT-adjusted real rate by 2019 would be no higher than -4½%. **Either way, this gives credence to the 'new normal' view of low-for-longer global rates and yields, rather than an imminent 'normalisation' to pre-crisis levels.**

Meanwhile, the FOMC will opine it's their cherished policy rate that needs to get closer to 'normal'. Yet, once QT gets under way, it may become clearer they needn't hike as far as the current dot-plot suggests - especially if inflation stays tame, the dollar lifts, and/or chair Yellen next February ends up being replaced by an even more pro-growth, Trump-nominated candidate.

Japan



With PM Abe's popularity waning, wages muted, and the deflationary psychology entrenched, he still has every incentive to prolong a policy loosening now in its nineteenth year. Economic activity *is* picking up. In *real* terms, GDP (growing 2.0%yoy in Q2) has for the first time since 2006 risen for as many as six consecutive quarters. This has been helped by a weaker yen and, linked to that, successive monetary and fiscal stimuli. But, it also reflects a deflation distortion where a falling price deflator boosts real activity. This constrains *nominal* GDP, by contrast, as deflation eats into higher real-activity. While real GDP lies 5¼% higher than the start of 2007, the level of nominal GDP is even now barely back to square one *(chart 1)*.

Steepness of the Phillips Curve suggests wage growth would knock-on to the CPI...

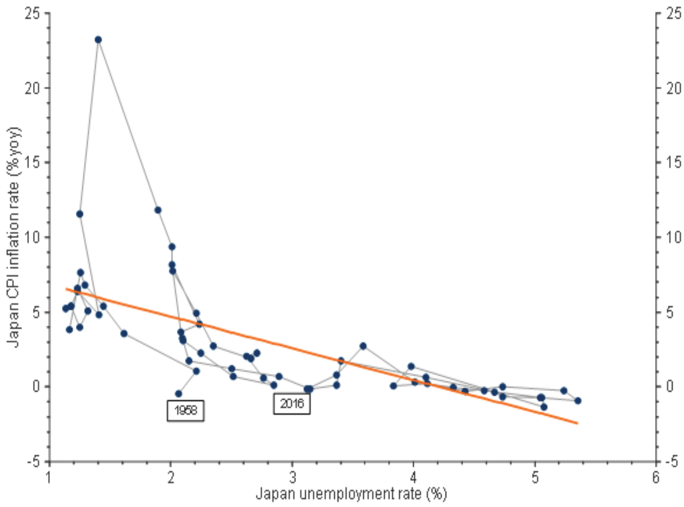
This is hardly sufficient for an economy running the developed world's highest government liabilities-to-GDP, at about 230%. It means the BoJ daren't cut back on QE. At ¥80trn per *annum* ($728bn) in total asset purchases - the vast bulk being JGBs, the rest ETFs and REITs - it's mopping up JGBs at twice the pace of net supply (¥36trn). The BoJ has under governor Kuroda doubled its share outstanding to 48%, which leaves private institutions chasing riskier assets and/or looking overseas for bonds to buy, helping to hold down the yen.

The MoF hopes that, by maintaining a nominal *growth rate* (in H1 averaging 1.2%yoy) above the average long-term interest rate, it can carry on borrowing without raising the debt ratio. But, this catch-22 precludes the BoJ from switching off, or even reducing, its QE. This leaves some officials believing the BoJ will be the last central bank to ever stop QE, and even eulogising the MoF/BoJ's debt symbiosis.

This deflationary psychology has also constrained wages and asset prices. Our Phillips Curve analysis ***(chart 5)*** suggests that, if delivered, wage growth would knock-on to the CPI, given the unemployment fall since 2009. BoJ research concurs, by identifying a negatively sloped curve, and a greater degree of long-term wage responsiveness than in the US. **Yet, the spring annual wage-round (*shunto*) was again tame, with the +2%yoy average, one-off wage-hike no higher than each of 2014-16's. These were not sustained, and political pressure on firms to raise wages will continue to build in FY18 (year starting April '18).**

Chart 5. More aggressive wage rounds would help to spark inflation

Fitted 'Phillips curve', showing trade-off between unemployment & CPI inflation



Source: Thomson Reuters Datastream, based on Ministry of Internal Affairs & Comms

Another important consideration is land prices which, after falling for almost 25 years, is stabilising. Building momentum here will be important for inflation, balance sheets, and collateral. Falling land prices was the common link when the MoF raised the consumption tax in 1997 and again in 2014, and the BoJ in 2000 ended its zero rate policy. Each time, they had to back-track as consumption slumped. Little wonder the third leg of the consumption tax rise, from 8% to 10%, deferred officially to October 2019, may be abandoned.

This would, though, forego a near proportionate lift to the CPI, and its contribution to a ¥12½trn (2% of GDP) revenue lift from the last two hikes together. **Without plugging this gap, Abe's aim of a primary surplus by FY20 seems unlikely - even with a potential growth fillip from hosting the Rugby World Cup and Tokyo Olympics.**

Policy will thus have to stay ultra-loose to snuff out deflation. Abe's three-arrow strategy - of a looser monetary stance, expansionary fiscal stimulus, and longer-term structural reforms (labour market, corporate governance) - will continue. So far, payback has been limited. The BoJ has for 18 months been targeting explicitly a zero 'yield' on 10-year JGBs, but has disappointed by not broadening its negative policy rate (-0.1%) on banks' newly created reserve balances.

Kuroda has for the fifth time extended, to FY19, the BoJ's pledge to hit its +2%yoy CPI target. (This July's CPI was just +0.4%yoy.) His initial promise in FY13 to achieve it by FY15 was delivered only via the second consumption-tax rise (from 5 to 8%), which proved austere. This latest delay takes pressure off him before his term expires in April, but adds to the pressure on Abe to appoint an aggressively dovish successor.

And, especially with Abe's average approval rating below 30% for the first time in his near five-year tenure. Linked to allegations of favouritism, August's Cabinet reshuffle reappointing established members was then aimed at promoting stability ahead of 2018's Lower House election. There, the LDP will need to maintain its two-thirds super majority to pursue Constitutional reform in FY20. Scheduled for December 2018, it may be brought forward to avoid clashing with Emperor Hirohito's abdication ceremonies. **Either way, Abe should still test Koizumi's record of staying in office for five-and-a-half years.**

Economic & interest rate projections (p)

% yoy unless stated	'12	'13	'14	'15	'16	'17p	'18p
Real GDP	1.5	2.0	0.3	1.1	1.0	1.4	1.3
Private consumption	2.0	2.4	-0.9	-0.4	0.3	1.0	1.0
Business investment	4.2	3.9	4.9	1.1	1.4	3.0	2.0
Industrial production	0.2	-0.6	2.1	-1.2	-0.2	3.8	1.8
Consumer prices	0.0	0.3	2.7	0.8	-0.1	0.5	0.8
Unemployment rate (%)	4.3	4.0	3.6	3.4	3.1	2.8	2.7
Current account (% GDP)	1.0	0.9	0.8	3.1	3.8	3.7	3.8
Gen budget balance (% GDP)	-8.7	-8.5	-7.7	-6.7	-5.7	-6.0	-6.3
BoJ target rate (yr-end, %)	0.10	0.10	0.10	0.10	-0.10	-0.10	-0.25

Source: National data, Hermes Investment Management, OECD, & Consensus Economics

Euro-zone

While far from fixed, the worst of the zone's macro strains look behind us. Which is just as well, given the years it'll take to solve the underlying problem - a monetary union still bereft of economic union. GDP recovery's underway, with real activity back to its pre-crisis peak, and the 'big four' - Germany, France, Italy and Spain (together, 78% of euro-zone GDP) - all growing above their long-run 'potential'. But, with 2017 being such a highly-charged political year, any contagion, unlike 2008, was more likely to be political than financial.

France's competitiveness: still not improving

Avoidance of extreme outcomes in the Dutch and French elections have so far reassured markets. But, Dutch tensions with Turkey showed one country's referendum can spill over into another's election. And as the UK opens the EU trapdoor, many voters in Germany (24 September) and Italy's (spring 2018) elections may wish to approach it.

Last December's Italian referendum that rejected deeper government powers seems to have set the tone. Those 'smelling' a European equivalent of 2016's political shocks in the US and UK have so far been disappointed, but came close. Politicos had been expecting France's first round election to throw up Mrs Le Pen against a more mainstream candidate for the final. **Mr Macron, of course, won. But, his formation of new centrist party, *En Marche!,* before poaching high-level conservatives and socialists, is a visible sleight to the establishment.**

His party's National Assembly majority (60% of seats with centrist ally, MoDem) gives him a force for change. With monetary policy in the ECB's hands, his focus is on fiscal and structural reform. Mr Draghi's encouragement of governments that have *"fiscal space"* to take the baton back from the ECB gives added urgency to France and other new administrations. In theory, Mrs Le Pen probably had more scope than Mr Macron to expand fiscally, given euro-zone budget constraints would doubtless have played second fiddle to her domestic agenda.

But, while seemingly positive for France's growth in the short term, this impulse would then have been offset by higher long-term rates, as markets suspected (probably rightly) that her fiscal reflation came at the cost of ungluing France's commitment to the euro and EU. Unhelpfully, this fear would have forced up other euro members' long rates - exacerbating debt strains, re-widening 'peripheral' government bond spreads, and necessitating even more QE from Mr Draghi.

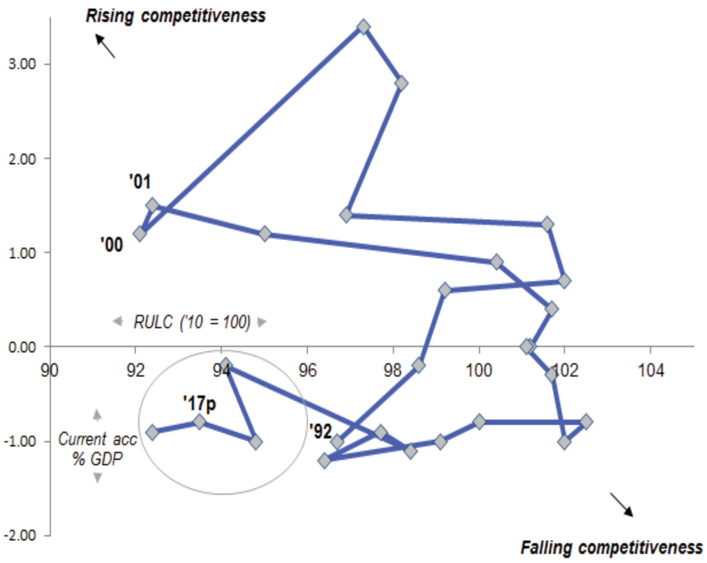
Economic & interest rate projections (p)

% yoy unless stated	'12	'13	'14	'15	'16	'17p	'18p
Real GDP	-0.9	-0.2	1.3	1.9	1.7	2.0	1.8
Private consumption	-1.2	-0.5	0.8	1.8	2.0	1.7	1.6
Fixed investment	-3.3	-2.4	1.6	3.0	3.4	3.0	2.0
Industrial production	-2.3	-0.7	0.8	2.1	1.4	2.0	1.8
Consumer prices (HICP)	2.5	1.3	0.4	0.0	0.2	1.5	1.3
Unemployment rate (%)	11.4	12.0	11.6	10.9	10.0	9.4	8.8
Current account (% GDP)	1.4	2.2	2.5	3.2	3.5	3.0	2.9
Gen budget balance (% GDP)	-3.6	-3.0	-2.6	-2.1	-1.5	-1.6	-1.9
ECB refi' rate (yr-end, %)	0.75	0.25	0.05	0.05	0.00	0.00	0.00

Source: National data, Hermes Investment Management, OECD, & Consensus Economics

Chart 6. France's competitiveness has deteriorated since the euro

Relative unit labour costs (RULC), vs current account as % GDP. Selected years in bold.



Source: Hermes Investment Management, based on OECD data

By contrast, the more pro-EU Mr Macron wants to contain fiscal expansion to avoid de-stabilising the euro. France's deficit-to-GDP ratio is about to settle around the 3% Maastricht yardstick, suggesting fiscal redistribution, rather than profligacy. **His proposals to reduce social contributions and make statutory work-time more flexible offer a 'shot in the arm' at a time when France's competitiveness is eroding.** Macron in 2012 objected to predecessor, Hollande's 75% 'super tax' (later cut to 50%) that raised the burden for employers.

Chart 6 uses the OECD's estimates/projections of France's unit labour costs in tradeable goods, relative to its main trading partners' (RULC). These are indexed to a 2010 base year (=100). A rising index indicates a *de facto* real effective exchange rate appreciation and falling competitiveness. (See our *Euro-zone - time for Plan B*, January 2017.)

As an amorphous bloc, the euro-zone is after seven years of austerity regaining competitiveness lost since the euro. Yet, shifts in individual members' competitiveness are still too disparate. **Germany (28% of euro-zone GDP) remains the relative winner, but most others have seen deterioration**. The good news is that Italy and Spain's shortfalls versus Germany are rapidly reducing. **Yet, France's (21% of euro-zone GDP) is closing more slowly than theirs. And, trying to boost it via austerity rather productivity carries economic and social costs.**

As *chart 6* attests, France's competitiveness has seen two phases. First, strong gains just after 1992 when the Maastricht criteria offered policy discipline. This allowed France in 1999 to be one of only three original euro-joiners (with Luxembourg and Finland) to pass the tests. Then, once in the euro, discipline waned as it did for others like Greece. **And, France's lack of improvement since leaves its current position little better than when Maastricht 'started'.** This contrasts with Italy and Spain who turned painful austerity into competitiveness gains.

Aimed at a deeper Europe, Macron also advocates a euro-wide budget overseen by a single Minister of Finance. This would, for example, make more feasible a 'helicopter money' drop, akin to the US's in 2001 and 2008. But, while Germany sees this as a step too far - backdoor debt-sharing and mutual euro issuance - it would, though, surely approve of Macron's convergence-enhancing labour reform.

United Kingdom

With the BoE looking loathe to raise rates during the Brexit process, and the pound still vulnerable, any policy correction is more likely to come from the fiscal side. But, even this will be slight, and relative only to the current starting point (a budget deficit around 3% of GDP), rather than disrupting chancellor Hammond's plan to gradually return that deficit to a surplus *"...sometime in the next Parliament"* starting in 2022. His predecessor, Osborne, had wanted surplus by 2019/20, which reflects the loosening relative to *previous plans* already in train. And, with Brexit looming and pay pressure in the public sector, there could be a lighter touch in the autumn Budget, albeit (with Brexit yet be financed) partially offset in other areas.

BoE seems loathe to tighten before Brexit, keeping monetary conditions ultra loose...

Which leaves the BoE watchful that a weaker pound doesn't keep pumping inflation. Even if the worst of Brexit is priced in, the pound has limited upside. Our analysis suggests no major economy has in the long-term net loosened its overall (monetary and fiscal) stance more than the UK. And, given the inflation premium, there's little coincidence those running expansionary policies sustain the weaker currencies.

Yet, BoE staff believe it takes up to four years for higher import prices to be fully passed on to a CPI basket that is about one-third imported. Some suggest that pass-on thusfar (about 40%) has been milder than expected, with the shortfall presumably being cushioned in margins.

Should the pound plummet and/or protectionism build, inflation will reappear. Our simulations show, at current USD/GBP and oil prices, RPI inflation peaking at 4.0%yoy in Q4. But, combinations of a weaker pound and/or higher oil could lift it to 5¼%yoy. This would be a six-year high. In each case, the CPI stays easily above its +2%yoy target, with further GBP weakness/oil strength lifting it as far as +3.4%yoy.

But, it will be the 'wrong sort' – cost-push, rather than 'feel-good' demand-pull. This portends more to the inflation rises of the early 1980s and 1990s UK recessions, than the overheating of the late 1980s and mid-2000s. **In which case, the inflationary flame may snuff itself out. The MPC could feasibly reverse its 25bp 'safety net' Bank-rate cut from last August. But, in the absence of a recovery in real (private-sector) wages, we doubt they would hike more aggressively.**

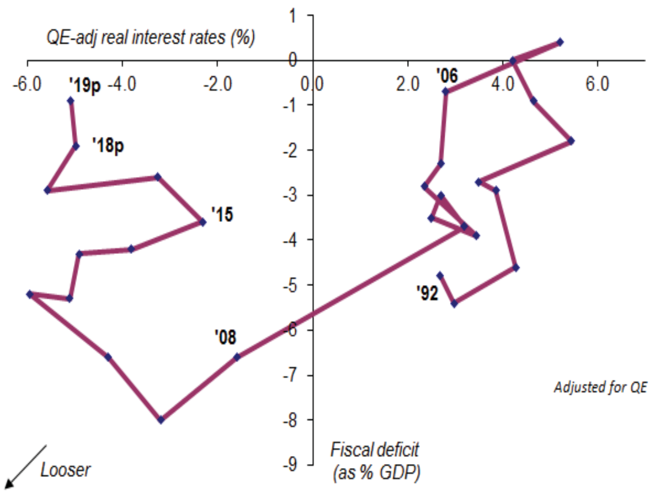
Economic & interest rate projections (p)

% yoy unless stated	'12	'13	'14	'15	'16	'17p	'18p
Real GDP	1.3	1.9	3.1	2.2	1.8	1.6	1.2
Household consumption	1.9	1.6	2.1	2.5	2.8	2.0	1.4
Fixed investment	2.4	3.2	6.7	3.4	0.5	1.0	-1.0
Manufacturing production	-1.5	-1.0	2.9	-0.2	0.7	1.3	1.0
Retail prices index	3.2	3.1	2.4	1.0	1.7	3.5	2.6
Consumer prices	2.8	2.6	1.5	0.0	0.7	2.5	1.9
Unemp, ILO rate (3m av, %)	8.0	7.6	6.3	5.4	4.9	4.6	4.9
Current account (% GDP)	-3.7	-4.4	-4.7	-4.3	-4.4	-3.6	-3.2
Gen budget balance (% GDP)	-7.3	-5.9	-5.0	-3.8	-2.6	-2.9	-1.9
BoE Bank rate (yr-end, %)	0.50	0.50	0.50	0.50	0.25	0.25	0.25

Source: National data, Hermes Investment Mgmt, OBR, OECD, & Consensus Economics

Chart 7. The UK's macro policy mix, adjusted for QE

Using QE-adj Bank rate, CPI, & cyc-adj fiscal balance as % GDP. Years in bold.



Source: Hermes Investment Management, based on OECD, OBR, & Bloomberg data

To gauge how the overall policy position should shift, we update (as we do on *page 3* for the US) our *'Policy Looseness Analysis'* to 2019. In ***chart 7***, we have adjusted the policy rate for the BoE's 2009 estimate that £200bn in QE was akin to 150bp off the Bank rate. **Extrapolating, the cumulative £445bn QE since 2009 (including the extra £70bn announced after the Brexit vote) thus implies a UK policy rate of about -3%: way lower than the 0.25% official Bank rate.**

The MPC hopes that productivity begins to lift from 2018, justifying higher wage claims. If it does, they could admittedly then get twitchy fingers. But, they do have another lever to pull to cap the rise in Bank rate, by beginning to wind down their £445bn balance sheet. We estimate the trade-off from peaking out at a historically low rate could over time be to wind down over half of their QE-bought bonds, though governor Carney so far seems to advocate gradual hikes before QT.

Meanwhile, with Brexit still the 'known unknown', the MPC will try hard to resist jumping on the coattails of the US Fed. Its reluctance to take back last August's rate cut when it released its latest *Quarterly Inflation Report* was an opportunity missed to follow through on June's more hawkish messaging from Carney and Haldane. The MPC's more benign forecast seemed to reflect a shaving down of their productivity assumptions, and the extra rate hike assumed by money markets, that had been in part triggered by the MPC's own messaging!

It would also meet their stated aim of getting back some 'powder' to use, should the economy slow further. The balance of course is making sure that higher rates do not cause that downturn, so it's encouraging that *"...tradition has gone"* (Carney, 3 August) in terms of the MPC considering a straight-line upward path for rates.

Which leaves drastic action 'off the table' till 2019 when Brexit is assumed to occur. The Conservatives' Brexit timetable, though, (negotiations to November 2018, followed by six months' ratification in Brussels/Parliament, before a two-year settling-in period before the election in 2022) looks optimistic. **So, meanwhile, tapering the BoE's reinvestments would surely be the gentlest way of tightening. And, if it helps facilitate *"the smooth Brexit"* Carney craves, he have his 'cake' (unhindered consumption) and 'eat it' (still low policy rates).**

China

Efforts will remain centred on playing down any hints of financial disruption ahead of President Xi's Politburo reshuffle at this autumn's nineteenth national congress of the Communist Party of China (CPC). With Xi having entrenched his position as General Secretary of the CPC and Chairman of the Central Military Commission, he's become the CPC's most powerful leader since Deng Xiaoping up to 1989. And, with five key members reaching age limits, his opportunity now to appoint additional allies (including probably the reappointment of Premier Li) should secure his majority on the key policy-making Politburo Standing Committee, and ensure political stability through to the twentieth congress in 2022 (when he himself turns 69).

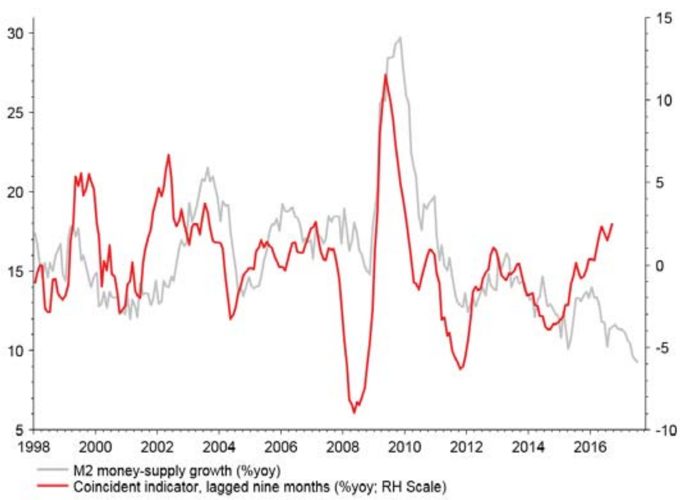
President Xi's autumn appointments should ensure his tenure through to 2022

But, once this autumn's out of the way, the policy landscape could look different. On the macro front, Xi and his allies should be in a stronger position to focus on the priorities set out in last December's annual Central Economic Work Conference: of containing asset price bubbles; rising corporate debt; and managing shadow banking.

By allowing key money market rates to drift up, the PBoC has since signalled to banks to rein in credit expansion, as it tries to cool the overheating housing market. Real estate price-inflation is cooling but remains close to double-digits, while 'affordability' (the ratio of average house prices to incomes) of 10-30 in the main cities has deteriorated faster than in other world centres.

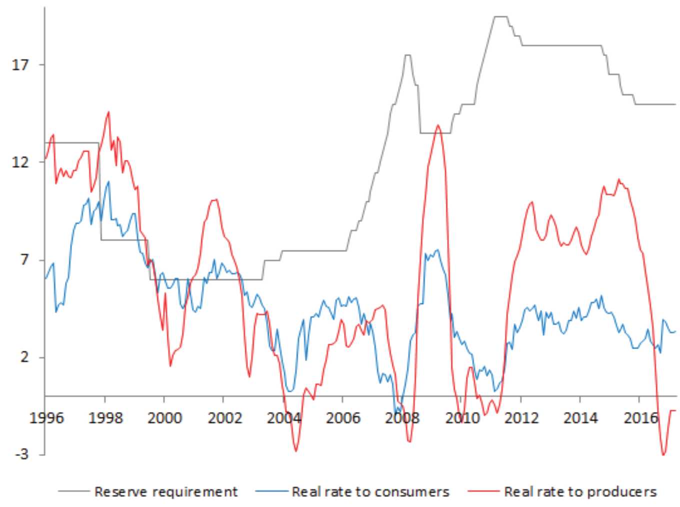
With Xi's hand strengthened, there may appear next year to be a less growth-friendly approach. But, even this should be relatively gentle, suggesting little more than a token tightening cycle. Maximising growth - *"around the 6½%yoy"* needed to double 2010's GDP level by 2020 - and employment are likely to remain the CPC's long-term objectives. This will leave the authorities mindful that restricting credit too far risks a more pervasive slowdown ***(chart 8).*** So, after a significant fall in real borrowing costs ***(chart 9)***, money rates could edge up further as the PBoC addresses these issues, and continues to 'import' US monetary policy by roughly maintaining its quasi-peg against the USD.

Chart 8. More slowing to come?...
Shows coincident indicator, lagged nine months, & M2 growth (%yoy)



Source: Thomson Reuters Datastream, based on NBS, & PBoC data

Chart 9. But, there's less scope now for monetary loosening
China's 3-5yr lending rate deflated by CPI/PPI, vs RRR for small banks (all %)



Source: Thomson Reuters Datastream, based on NBS, & PBoC data

Should the economy suffer, fiscal policy could be loosened to boost the supply side, *"cutting business taxes and ensuring incomes"*, and if needed the renminbi allowed to soften. Till then, the immediate concern has been to avoid another haemorrhaging ($1trn since 2014) of forex reserves, and take back some control of the currency, as individuals eat again into their $50,000 *per annum* outflow limit. The renminbi's fall since 2015 has since been stemmed by imposing capital controls, and since last October allowing money rates to drift up.

But, tellingly, the RMB has been allowed to fall fastest during bouts of global influence, such as rising US rate expectations in Q4 2015; Brexit fears in Q2 2016; and higher, Trump-inspired US inflation expectations in Q4 2016. **The likely persistence of these forces and the risk of protectionism as China's bilateral surplus with the US builds, thus suggest some further downside for the RMB.**

For as long as 'free' trade continues, this should be gradual. The PBoC's preference is to avoid undue downward pressure on the renminbi, partly to avoid restoking outflows. Given currency depreciation effectively 'taxes' consumers (via inflation) over exports, 'gradual' fits with the aim of rebalancing which has stalled since 2008. Politically, the PBoC's various interventions since 2014 to *contain* CNY/USD depreciation - including its trade-weighted basket in 2015 - water down accusations of it being a downward currency manipulator.

Yet, the more serious risk is US trade tariffs. It remains to be seen how more combative US/China relations become after the autumn over N. Korea. Retaliation by China to any US protectionism could yet be sought by *inter alia* a large, 'bazooka' devaluation that clawed back some of the competitiveness-hit. This in turn risks imploding China's corporate and banks' balance sheets most exposed to USD debt and, to cushion the impact, the PBoC having to delve into $3.1trn reserves.

In which case, an uneasy mix of currency depreciation, lower reserves, and selective defaults may be the least disruptive option for Xi, especially if he can blame them on the US. Slower world trade would also make it easier for him to explain any shortfall from his growth target. Hopefully, though, China's sizeable US Treasury holdings (about 15% of total) for one provide a mutual deterrent.

HERMES
INVESTMENT MANAGEMENT

OUTCOMES BEYOND PERFORMANCE

Hermes Investment Management

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns - outcomes for our clients that go far beyond the financial - and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets
Infrastructure, Private Debt, Private Equity, Commercial and residential real estate

High active share equities
Asia, global merging markets, Europe, US, global and small & mid-cap

Credit
Absolute return, global high yield, multi strategy, global investment grade, real estate debt and direct lending

Multi asset
Multi asset inflation

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

Offices
London | New York | Singapore

Our recent macro reports include...

2017

- US Fed - addressing the balance sheet (2 August)
- Brexit - speed bumps, slopes, & cake (3 July)
- The wrong sort of inflation (6 June)
- Tightening by doing nothing (2 May)
- Europe's highly-charged year (3 April)
- Beggar thy neighbour (1 March)
- Brexit - has the fog lifted? (1 February)
- Euro-zone - time for Plan B (4 January)

2016

- Looking into 2017 (5 December)
- US - after the election (1 November)
- Living with the 'new normal' (4 October)
- When the solution becomes a problem (5 September)
- Brexit - once the dust has settled (July/August)
- Time to open the other box? (6 June)
- Brexit - the wider picture (4 May)
- Euro-zone - converging on the best? (4 April)
- Losing sight of the triggers (8 March)
- Brexit - the known unknown (1 February)
- Euro-zone - closing the gap (6 January)

2015

- Looking into 2016 (1 December)
- China crisis? (3 November)
- Rates back to normal? 'Pull the other one' (2 October)

Contact information

Hermes Investment Management

Neil Williams, Group Chief Economist +44 (0)20 7680 2398 neil.williams@hermes-investment.com

Business Development

United Kingdom	+44 (0)20 7680 2121	**Africa**	+44 (0)20 7680 2205	**Asia Pacific**	+65 6808 5858
Australia	+44 (0)20 7680 2121	**Canada**	+44 (0)20 7680 2136	**Europe**	+44 (0)20 7680 2121
Middle East	+44 (0)20 7680 2205	**United States**	+44 (0)20 7680 2136		

Enquiries marketing@hermes-investment.com