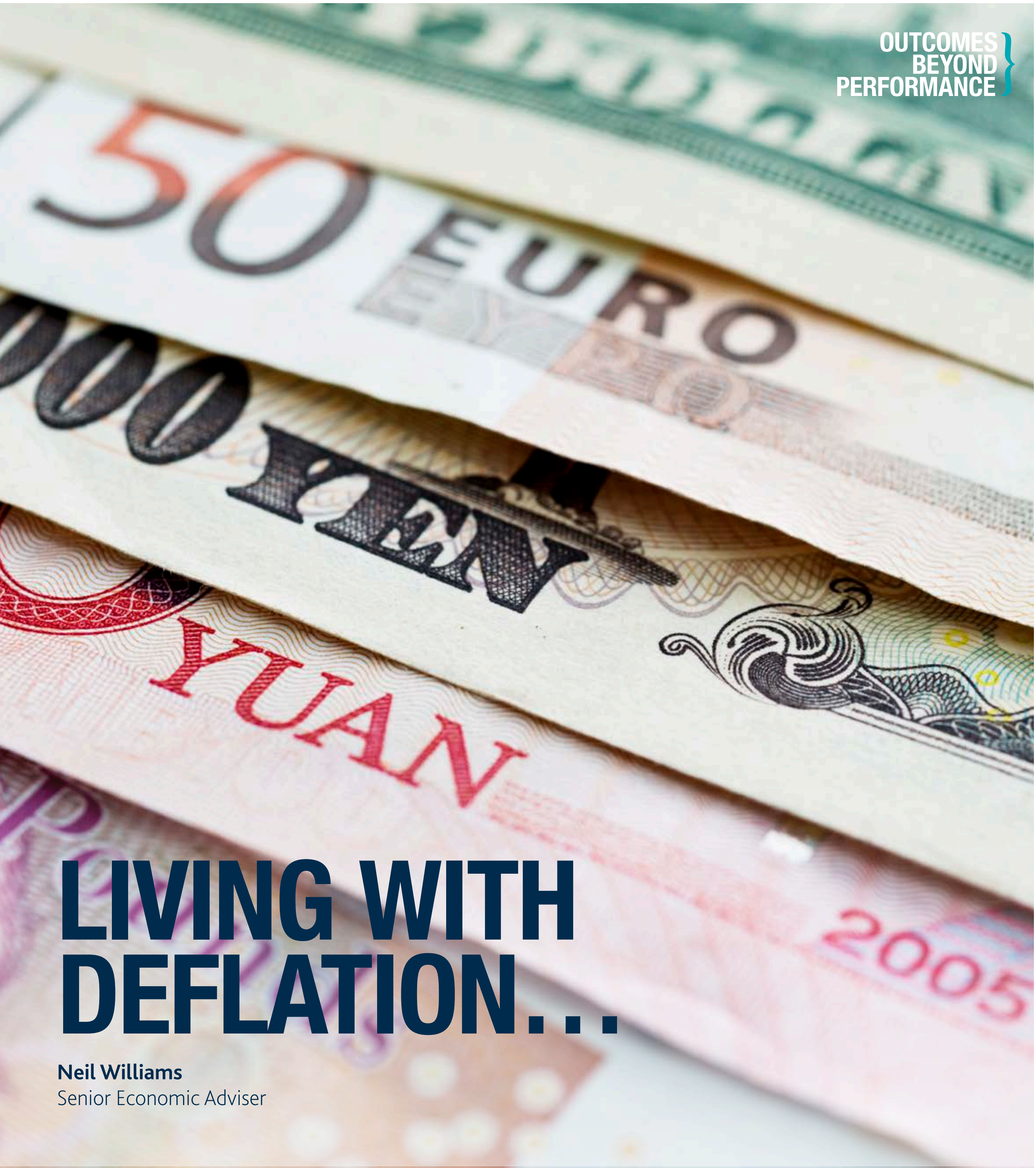

OUTCOMES BEYOND PERFORMANCE

LIVING WITH DEFLATION…

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Q4 2019

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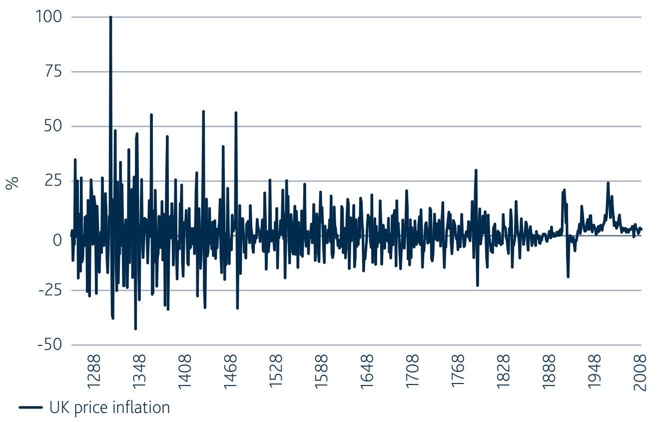
HERMES INVESTMENT MANAGEMENT

MAIN POINTS

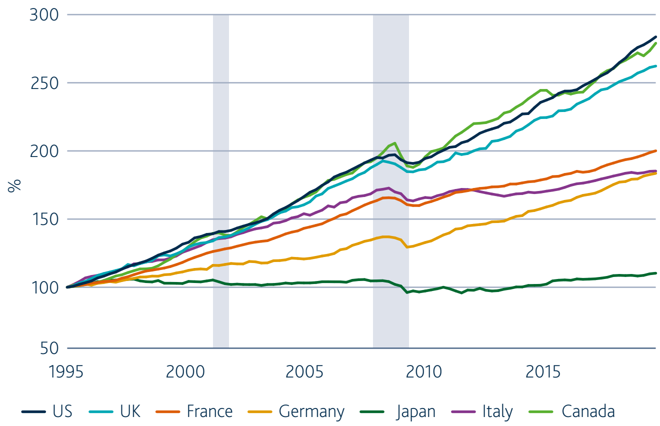
- After a decade, central banks that are still not getting the inflation they crave are reverting to the tools that failed them. QE's boost to asset prices has become counter-productive – widening disparities, stuttering demand, and stymying inflation.
- With central banks scared of their own shadows, the risk to markets comes more from protectionism. The 1930s revealed few winners. Stagflationary forces should mean the cost-led inflationary flame snuffs itself out. Helpfully, ultra-cheap borrowing costs are offering incentives to governments to open the fiscal box.
- This has modern precedent in deflationary Japan. Deflation historically has not been uncommon, with the UK since Medieval times spending almost as much time in deflation as inflation. It offers benefits. With 'cash as king', savers would be rewarded over borrowers, providing funds for capex, productivity, and wage growth.
- Yet, if we are going down the Japan route, a sizeable shift in mind-set would be required. For investors, the renewed attractiveness of cash may expose competing financial instruments offering inadequate premia. For growth assets, this could herald absolute falls, putting even sharper focus on relative price-shifts within asset classes.
- Consumers' reaction would be influenced by the speed of wage falls relative to the falls in shop and asset-prices. If resisted, the pressure release to margins may have to come from employment reductions and/or more flexible working. Key will be making sure the extra saving is diverted efficiently into higher capex and productivity.
- However, it's debtors/governments who probably face the biggest risk. The US, eurozone, and UK government's debt-ratios are already twice Japan's was when it entered its 'lost decade'. Were their nominal GDP now held back by deflation, even a modest 1%yoy rise in the debt stock would lift their respective net ratios to 105%, 80%, and 100% by 2040! This wipes out government hopes of eroding the debt via inflation.
- The QE-drug would, thus, be even more difficult to kick, especially as central banks' skin in the game leaves them striving for the status quo. Precedent and current government dependence on their central banks suggest we may be little more than half-way through our QE.
- Meanwhile, the challenge may not be a general hit to living standards, but a deflationary psychology where we celebrate our pay cuts if they prove tamer than the price-fall of the holiday, car, or house we're seeking. And, we doubt London, New York, Frankfurt, Paris, Rome etc are ready for that!...

Chart 1. Price-deflation has not been uncommon historically...
Shows, as a guide, estimated UK price-inflation (%yoy) since Medieval times (1265)



Source: Univ. of California price estimates up to 1750, & ONS thereafter (RPI since 1947)

Chart 2. GDP levels since Japan has had (economy-wide) price-deflation
Nominal GDP re-based to Q1 1995 (=100). Grey blocks denote US recessions



Source: Refinitiv Datastream, based on national data

COMMENT

After a decade, central banks still not getting the inflation they crave are reverting to the tools that failed them. The US's latest rate-cut marks an usually abrupt strategy-shift, and its ending of QT confirms 'normalisation' has failed everywhere (page 3). The ECB is re-opening the tap (page 5), and the UK looks ready to ease on three fronts (page 6). All this adds to pressure on the BoJ to prolong a policy-loosening spanning over 20 years. Its addiction to QE means it may never kick it, reinforcing our concern that QE's now more a problem than the solution. It's a neat coincidence that these central banks' $15trn of QE tallies with the circa $16trn of negative-yielding bonds; if only QE were that predictable. In reality, its boost to asset prices has become counter-productive, benefitting those that probably need it least – widening disparities, stuttering demand, and stymying inflation.

Deflation – we're not ready for the mindset change

The risk to elevated markets, thus, comes not from central banks scared of their own shadows, but protectionism. The 1930s revealed few winners from a trade war. Should stagflationary forces build from such a supply-shock (our base case), the cost-led inflationary flame will snuff itself out. Helpfully, ultra-cheap borrowing costs now offer incentive to governments to open the fiscal box, albeit so far at a staggered pace (expansionary in the US/Japan, lagging in the eurozone/UK). All this has modern precedent in deflationary Japan. And, while differences exist, even these are not reassuring (see our 'Japanification' report, Q3 2019).

Despite current fears, deflation historically has not been uncommon. As a guide, the UK has since Medieval times spent almost as much time in deflation (a reduction in the general level of prices) as inflation, typically determined by shifts in commodity supplies, harvests, and wars. Only since WWII has inflation been considered 'the norm', perhaps reflecting global trade, labour laws, inclusion of house prices, taxes, currency falls etc (chart 1). Indeed, deflation offers a number of economic benefits. With 'cash as king', savers would again be rewarded over borrowers, providing funds for capex and productivity. This raises scope for wage rises (the 'Holy Grail' for policy makers), while exposing 'zombie' firms.

In practice, Japan has become the G7's benchmark for deflation. Tumbling asset prices from 1991 contributed to economy-wide price falls (negative GDP-deflator) by 1995, and a correction that's still playing out (page 4). Yet, for all its shortfalls (falling land prices and wages, seven GDP-recessions), Japan remains a prosperous, G3, $5trn economy (almost twice the UK's) with social cohesion. Its GDP-per-head has risen over the period. But, the biggest challenge to economic agents heading down the Japan route would surely be the sizeable shift in mind-set required.

Firstly, for investors, the renewed attractiveness of cash may expose competing financial instruments offering an inadequate premium. For growth assets (e.g. equities, credit), this could herald absolute falls, putting even sharper focus on relative price-shifts within asset classes. The Nikkei from the late 1990s drew support from internationals seeking value, while domestics off-loaded. JGBs experienced the opposite: buoyed by a domestic investor-base, borrowing at zero for a positive (with deflation) real yield backed by BoJ-buying. A mix of deflation, ultra-low rates and QE in the US, eurozone, and UK would surely deliver similar patterns.

Second, consumers' reaction to a period of falling wages would probably be influenced by its speed relative to the falls in shop and asset-prices. Stronger labour militancy in other G7 economies and more regular pay reviews (Japan's centre on the spring shunto), especially amid populism in the US and UK and reform-fatigue in the eurozone, suggest greater resistance to wage cuts. So, the pressure release to margins may have to come more from other labour-market adjustments, such as employment reductions and/or more flexible working. In which case, a challenge to firms and workers would be to offset this down-drift in wages by making sure the funds from extra saving are diverted efficiently into capex and higher labour productivity.

Chart 3. And the legacy is debt build-up
Government gross & net liabilities as a % of GDP. *1998 data; **2000 data

	Moody's local ccy	1997 Gross	1997 Net	2019e Gross	2019e Net
US	Aaa	62	44	110	85
Japan	A1	102	34	226	126
Euro-zone	n/a	81	51	101	63
UK	Aa2	55	33	112	80
Greece	B1	96	70	183	141
Italy	Baa3	129	101	151	122
Iceland	A3	47*	17*	62	6
Ireland	A2	61*	41*	71	44
Latvia	A3	53**	n/a	44	17
OECD av		72	41	110	66

Source: OECD, & Moody's Investor Services

Third, the implications for debtors/governments, who probably face the biggest risk from deflation. While boosting real activity (i.e. nominal GDP is adjusted by a falling deflator), nominal GDP levels would be eroded. Chart 2 illustrates the extent of Japan's nominal-GDP underperformance during its deflation. After 24 years, it's barely back to square one. With deflation raising the real value of debt, and deflation and growth-slowdown eating into nominal GDP, debt-ratios monitored by ratings agencies are blown up.

Worryingly, the US, eurozone, and UK government ratios are already twice what Japan's was when it entered its 'lost decade' (chart 3). Japan 'gets away with it' by having all its JGBs local-currency denominated, held predominately (97%) by a domestic investor-base less sensitive to yield/foreign-currency ratings. The US, eurozone, and UK's too are in local currency, also implying default-risk is next to zero. But, with up to 40% of theirs owned internationally, "the kindness of strangers" (Carney) will hinge more on yield/ratings considerations. And, were the US, eurozone, and UK's nominal GDP now held back by deflation, even a modest 1%yoy rise in debt would lift their respective net ratios to 105%, 80%, and 100% by 2040! This wipes out government hopes of eroding the debt via inflation.

As for emerging markets, the outlook in a deflationary, more protectionist, stronger USD, world be less rosy. Vulnerabilities lie with those non-commodity exporters with high exposure to short-term USD debt and foreign saving needs, including Argentina, Turkey, Ukraine, South Africa. But, for others, external debt-ratios are lower, with few currency pegs to have to protect. And, where domestic debt climbs, they too could run QE.

For policy, the implications are clear. Deflation, stagnant GDP, and rising debt suggest the QE-drug will become even harder to kick. The last time proper was the US pulling out of the 1930s depression. Then, QE ran for 14 years to 1951, despite double-digit inflation touching 20% in 1947. This was a different time, but, if a guide, we may be little more than half-way through our QE. After all, central banks' skin in the game via bloated balance sheets suggests they, like the BoJ, will strive for the status quo. And, if they don't, mandates could change, especially with traditional reaction-functions (CPI targets, Phillips Curves) looking broken.

In 1951, the US Treasury-Federal Reserve Accord was the reason for stopping QE. This will not be repeated, and if anything (risk case) could even be revoked – formalising the dependence QE-governments now have on their central banks. Meanwhile, the challenge for us may not be a hit to living standards, but a deflationary psychology in which we celebrate our pay cuts if they prove tamer than the price-fall of the holiday, car, or house we're seeking. And, we doubt London, New York, Frankfurt, Paris, Rome etc are ready for that!

UNITED STATES

The Fed's first rate-cut for nearly 11 years, to 2.25%, leaves the door open for more – marking an usually abrupt shift (about six months) from a tightening to loosening bias. Growth is above-potential (averaging 2.5%yoy in H1 2019); the unemployment rate is close to a 50-year low; and real GDP is 21% up on its pre-crisis peak. With a shrunken output gap, perkier wage growth, and a decade-long business cycle – the NBER's longest since 1857 – the short-term outlook is constructive. But, worrying the FOMC are "muted inflation pressures" and "global developments" (July Statement). Inflation expectations are no higher than when QE started (chart 4). They remain sufficiently anchored to the Fed's preferred 2% level that faster wage-growth (averaging 3% since 2018) can be tolerated. Should protectionism build (our base case), the FOMC may have to accelerate its rate-cuts in 2020 to avoid recession.

Fed will now be led by inflation & protectionism…

Trade tariffs have so far been piecemeal. But, while limiting President Trump's ability to impose 'wildcard' measures, Congress may not be able to preclude his widespread use of 'Super 301' (Section 301 of the 1974 Trade Act) to deepen his protectionist stance. This has not been used pervasively since the WTO's formation in 1995. Yet, US disaffection with the WTO, retaliation by China, and Trump's need to keep favour into November 2020's Presidential election offer extra incentives to play this card. Democrats may thus, in practice, have a much weaker hold over trade policy than their rhetoric suggests.

Meanwhile, the Fed may want to move back only gradually to negative real rates. With US mortgage rates typically priced off the long bond, the circa 50bp yield-fall since the Fed's cut reinforces the effect. The 'Taylor rule' based on the Fed's current expectations pitches the funds target at about 2.5%, if the non-accelerating inflation rate of unemployment (NAIRU) is 4.2%. Or 2%, if the NAIRU lies close to the 3.7% average unemployment the FOMC expects to 2021.

Yet, by taking account of QE, QT and the fiscal outlook, our 'Policy Looseness Analysis' suggests a true funds rate closer to -2%, or -4% in real terms. (See our 'Tightening by doing' nothing report, May 2017.) Using this, chart 5 confirms the Fed will fall easily short of taking the de facto real rate anywhere close to its pre-2008 levels – with Trump's 2017-2019 fiscal expansion offering an additional support to growth.

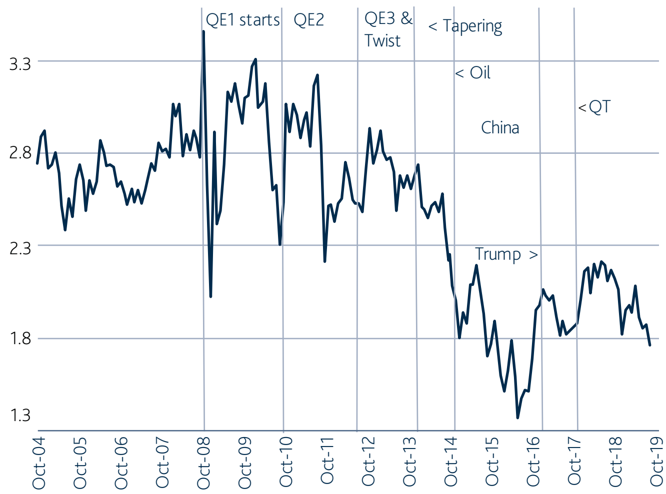
Economic & interest rate projections (p)

% yoy unless stated	'14	'15	'16	'17	'18	'19p	'20p
Real GDP	2.5	2.9	1.6	2.4	2.9	2.3	1.6
Personal consumption	2.9	3.7	2.7	2.6	3.0	2.3	1.8
Business investment	6.9	1.8	0.5	4.4	6.4	3.5	2.2
Industrial production	3.1	-1.0	-2.0	2.3	4.0	2.0	1.2
Consumer prices (nsa)	1.6	0.1	1.3	2.1	2.4	1.9	2.4
Unemployment rate (%)	6.2	5.3	4.9	4.4	3.9	3.6	3.8
Current account (% GDP)	-2.1	-2.2	-2.3	-2.3	-2.4	-2.2	-2.0
Fed budget balance (% GDP)	-2.7	-2.6	-3.1	-3.4	-4.2	-4.4	-5.0
Funds target (yr-end, %)	0.25	0.50	0.75	1.50	2.50	2.00	1.25

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

Our analysis also incorporates the Fed's now even-more dovish QT plans. QT was stopped in August – two months earlier than was planned even as recently as March. It ends a QT-period of just two years, and evidences the Fed, as test-case for rate and QE-normalisation, as having failed on both fronts. The latest plan implies a near halving of QT in 2019 (from $600bn to $305bn) compared to the initial aim in September 2017 of sustaining it at Q1 2019's pace. On the basis of the Fed's own QE trade-offs (and assuming symmetry for QT), this total $295bn QT-saving in 2019 is itself equivalent to precluding a de facto 25bp rate hike – which, if sustained, should reinforce the stimulus from lower yields.

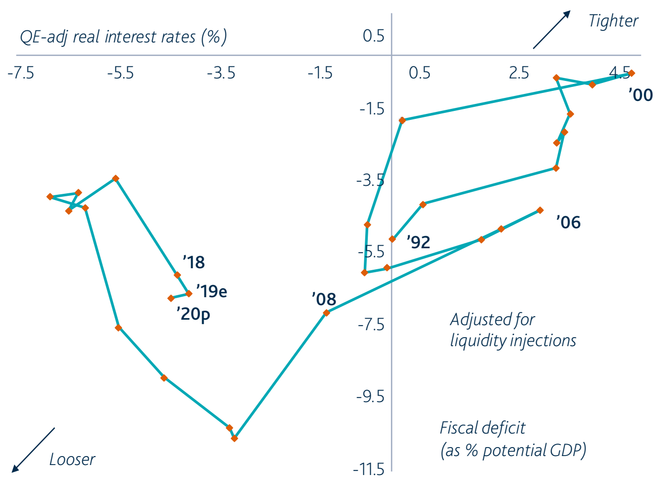
Chart 4. US inflation-expectations are barely back to square one
US Fed's five-year forward breakeven inflation rate (%)



Source: Bloomberg, based on Federal Reserve Board data

So, with fiscal correction improbable into the election, policy will remain exceptionally loose relative to the maturity of the cycle. And, helpfully, upheaval will have been reduced by Congress' raising of the debt ceiling till mid 2021: i.e. after the election. 'Default' here is only via inflation, but political disruption would have ensued had it not been raised beyond the $22trn (103% of latest GDP) outstanding. This would've affected both sides, with obstructive Democrats also risking their chances, much in the way that Republicans 'contributed' to Clinton's re-election in 1996.

Chart 5. Illustrating how loose the US's macro policy-mix will stay
Using QE-adjusted funds target, core PCE, & cyc adj fiscal bal. Based on dot-plot median



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

JAPAN

With tax, trade, and political hurdles looming, and activity losing momentum, there's every incentive to prolong a policy-loosening spanning over 20 years. Previous measures (a weaker yen, rounds of monetary and fiscal stimuli) helped, with real GDP till the end of CY17 rising for two years. This was the second longest stretch since the 1990s' asset-price collapse. The output gap closed, suggesting a return, if growth could be sustained above its 1%yoy 'potential', to economy-wide inflation (positive GDP-deflator). But, these measures are losing their edge. With personal consumption lacklustre into October's likely sales-tax rise – contrary to its front-loading into 1997 and 2014's hikes (chart 6) – and the yen being held up by safe-haven flows, deflation's-end is not assured. This could be unpalatable into 2021's Lower House elections, when PM Abe's tenure ends.

The BoJ may be the last to ever stop QE...

So, his dogmatic call for a third tax-hike (from 8% to 10%) is a gamble. Yet, abandoning it would forego a near one-for-one lift to the CPI, and deprive the MoF of its part in a ¥13trn (2% of GDP) revenue-take from the 2014 and 2019 hikes together. It may have to be diluted further, giving back some of the MoF's hoped-for revenue boost from hosting the Rugby World Cup and Olympics/Paralympics. Either way, a primary surplus by FY20 (year to March 2021) looks unlikely, even if the revenue-fillip outlasts that from co-hosting the 2002 soccer World Cup.

Encouragingly this time, land prices (critical for balance sheets and collateral) are stabilising, having fallen for most of the past 25 years. Falling land prices was the common link when the MoF raised the tax in both 1997 and 2014. Each time, they had to back-track as consumption and inflation slumped. So, expect minimal, if any, unwinding of QE. The latest form is the BoJ's targeting since April 2016 of a near-zero yield on 10-year JGBs. The aim is to keep yield curves steep and debt-costs down – critical for an economy with the developed world's highest government liabilities-to-GDP, at approaching 230%.

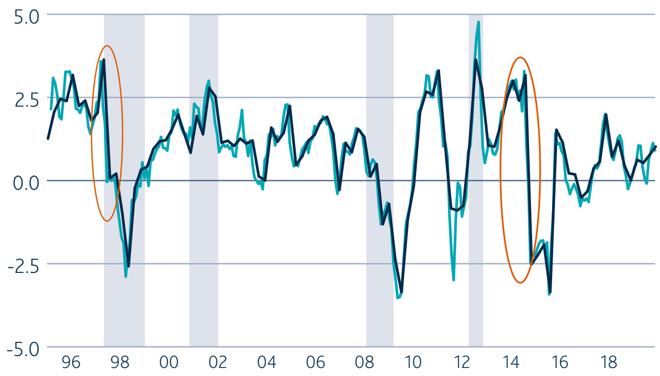
Deflation-denial in the 1990s, as the BoJ tightened, contributed to a correction that's still playing out. Tumbling asset prices from 1991 hurt banks' balance sheets and collateral, contributing to economy-wide deflation by 1995. This prompted banks to write off loans, and the BoJ in 1997-98 to mop up their commercial paper ('QE1'). However, it took till 2001 to get its key policy rate down to 0.1% and, with deflation expectations embedding and land prices falling, real rates stayed positive (chart 7). This needed more unconventional tools, including government bond QE. A symbiosis thus started, where the MoF presiding over escalating government liabilities became reliant on the BoJ.

Economic & interest rate projections (p)

% yoy unless stated	'14	'15	'16	'17	'18	'19p	'20p
Real GDP	0.4	1.3	0.6	1.9	0.8	0.8	0.5
Private consumption	-0.9	-0.2	-0.1	1.1	0.4	0.8	-0.1
Business investment	5.2	3.3	-1.5	3.9	3.9	2.3	1.0
Industrial production	2.1	-1.1	0.2	2.9	1.0	-1.0	1.0
Consumer prices	2.7	0.8	-0.1	0.5	1.0	1.1	1.5
Unemployment rate (%)	3.6	3.4	3.1	2.8	2.4	2.3	2.4
Current account (% GDP)	0.8	3.1	4.0	4.2	3.5	3.4	3.2
Gen budget balance (% GDP, FY)	-5.4	-3.6	-3.5	-3.0	-2.5	-2.8	-2.7
BoJ target rate (yr-end, %)	0.10	0.10	-0.10	-0.10	-0.10	-0.10	-0.10

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

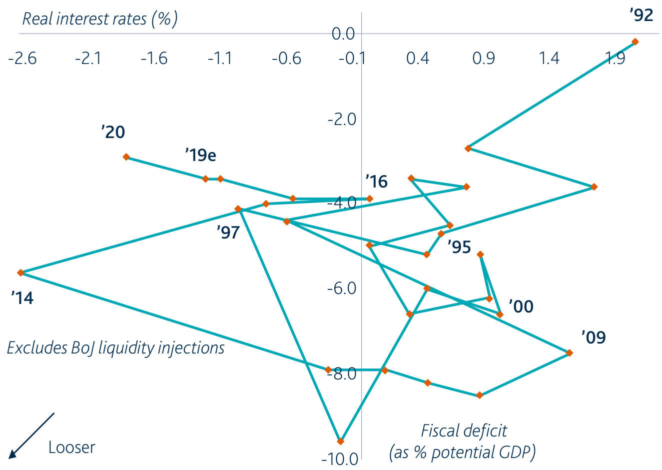
Chart 6. Personal consumption – only limited front-loading this time
Synthetic, & GDP-based, real consumption, %yoy. ESRI-defined recessions in grey



Source: Refinitiv Datastream, based on Economic & Social Research Institute data

At ¥80trn p.a. ($755bn) in asset purchases, the vast bulk being JGBs, the BoJ will continue to mop them up at twice the pace of net supply. Depending on where global yields go, this ¥80trn may vary depending on how much is needed to meet the low yield target. So, any rise at a zero/negative yield (likely) should be seen as loosening. For BoJ Governor Kuroda, there is no QE "reversal" until a +2%yoy CPI (latest +0.5%yoy) is the norm – presumably driven by demand, not taxes. Under him, the BoJ has doubled its share of JGBs outstanding to 50%, leaving institutions chasing riskier assets and looking overseas for bonds. The MoF will thus hope that, by keeping nominal growth above the average long-term interest rate, it can continue to borrow without raising the debt ratio – leaving some officials believing the BoJ will be the last to ever stop QE.

Chart 7. Japan's shift from overly tight, to historically loose, policy
Using 3-month rates, CPI, & cyc-adj fiscal balance. Based on our rate expectation



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

EUROZONE

With a highly-charged political climate, and our analysis predicting 2020 will see the joint largest macro-convergence between the 'periphery' and 'core' since the euro, any contagion should be political rather than financial. The ECB seems once to have fought off the main macro symptom, deflation. However, the solution – generating sufficient economic union to support the monetary union – may be years away. After nine years of austerity, electorates' reform-fatigue has become more visible, and the ECB is again raising its monetary impulse. Hopefully for growth, and with QE extending, Mr Draghi's appeal will be an extra 'green light' to governments that have "fiscal space" to take back the baton from the ECB, and to administrations (such as Italy's) elected on more populist mandates.

Political rather than economic divergence…

Governments are now preparing draft 2020 budgets to be submitted in October to Parliaments and the European Commission. In practice, highly-indebted members like Italy and Greece, vulnerable to rising debt-service costs, have especial interest in resisting a volte face that destabilises the euro. Yet, austerity has already sliced the eurozone's budget deficit from 6.3% of GDP in 2009 to under 1% – easily below the 3% Maastricht test for EMU. This makes it easier presentationally for fiscally-prudent Germany to turn a blind eye, and permit some fiscal relaxation as a complement to monetary easing. Absence of a single fiscal-agency may complicate the process, but this shouldn't preclude some autonomy within agreed, euro-friendly limits.

As a bloc, the eurozone is regaining competitiveness lost with the euro. Yet, shifts in individual members' competitiveness are still too disparate to rule our further strains. As a contrast, charts 8 and 9 use the OECD's latest estimates/projections of Spain and France's unit labour costs in tradeable goods relative to their 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 'Eurozone – time for Plan B', January 2017.)

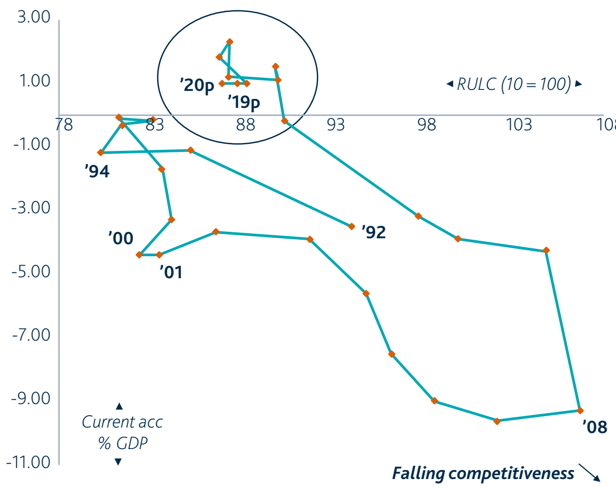
The good news is that Spain (and Italy's) shortfalls versus Germany are rapidly reducing. Yet, France's (21% of eurozone GDP) is closing more slowly than theirs. And, trying to boost competitiveness via austerity rather productivity carries economic and social costs. France's competitiveness has seen two phases. First, strong gains just after 1992 when the Maastricht criteria offered policy discipline. This allowed it in 1999 to be one of only three original joiners (with Luxembourg and Finland) to pass the tests. Then, once in the euro, discipline waned as it did for Greece et al. And, France's lack of improvement since leaves its current position little better than when Maastricht 'started'.

Economic & interest rate estimates (e) & projections (p)

% yoy unless stated	'14	'15	'16	'17	'18	'19p	'20p
Real GDP	1.5	2.0	1.9	2.5	1.9	1.1	1.2
Private consumption	0.9	1.8	1.9	1.8	1.3	1.2	1.2
Fixed investment	1.7	4.7	3.9	4.0	2.0	2.5	1.8
Industrial production	1.1	2.6	1.7	2.9	0.9	0.0	1.0
Consumer prices (HICP)	0.4	0.0	0.2	1.5	1.8	1.2	2.3
Unemployment rate (%)	11.6	10.9	10.0	9.1	8.2	7.8	8.0
Current account (% GDP)	2.5	2.7	3.1	3.2	2.9	2.8	2.6
Gen budget balance (% GDP)	-2.5	-2.0	-1.6	-1.0	-0.5	-0.8	-1.5
ECB refi' rate (yr-end, %)	0.05	0.05	0.00	0.00	0.00	0.00	0.00

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

Chart 8. Spain (& Italy's) competitiveness is improving rapidly…
Relative unit labour costs (RULC), vs current account as a % GDP. Years in bold

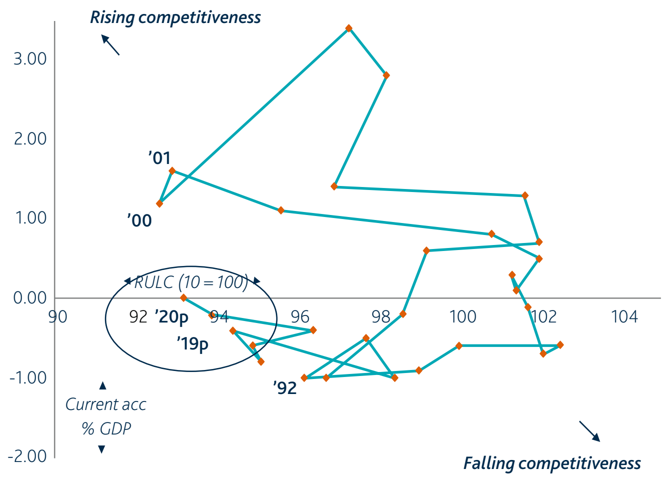


Source: Hermes Investment Management, based on OECD data

This contrasts with Spain which turned painful austerity and bank-support into an improved external position, recording its first full-year surpluses since the mid-1980s.

So, tackling the problem needs more than QE. Its effectiveness hinges on capping long rates, and, with roughly two-thirds of private borrowing (personal and corporate) long-rate, rather than short-rate, driven, stimulating demand. This is the mirror image of the UK. Without some targeted fiscal largesse, though, the challenge for new leaders (including Germany's) may be to avoid political divergence, as reform-fatigue builds.

Chart 9. But, France's is still lagging behind
Relative unit labour costs (RULC), vs current account as a % GDP. Years in bold



Source: Hermes Investment Management, based on OECD data

UNITED KINGDOM

Economics will continue playing 'second fiddle' to politics, with Brexit uncertainty likely to drag on well beyond PM Johnson's 31 October deadline. The situation is fluid. But, under current conditions and with Parliament so far unaccepting of a 'no-deal' Brexit, the door is open for elections and/or a Brexit process that may take years. Even if there is a deal by 31 October or next January (risk case), it would likely be a precursor to sorting out the various legal, trade, and regulatory systems (including the Irish border) during a transitional period that could extend beyond 2022. And, depending on the make-up of any new administration or interim government, this could even involve another referendum.

No other major economy has loosened more…

Eventually, to maintain ties, some form of satellite 'membership' (e.g. Norway's) and/or part-access to the Customs Union (Turkey) or Single Market (Canada) may be ruled in. Canada's took seven years for manufacturers only. But, each option would have strings attached (e.g. labour mobility), making it unpalatable to some. And new bilateral deals (e.g. the US) cannot be activated until Brexit is cleared.

High uncertainty will thus endure, raising the prospect of looser policy from up to three fronts. Since the UK recouped its pre-crisis nominal GDP in 2012, 'normalisation' came fiscally, with the BoE reluctant to raise rates, the pound vulnerable, and Governor Carney QT-resistant till Bank rate hit 1.5%. The nuance since 2016's referendum, though, has been a loosening of the fiscal reins, relative to previous plans. A lighter touch has come from 4 September's Spending Review, though, caught in the eye of the Brexit deadline, a full Budget could be deferred. Cutting the deficit to under 2% of GDP affords tax cuts. Yet, with Brexit dues to be negotiated, even a new administration may be wary of showing unbridled profligacy early on.

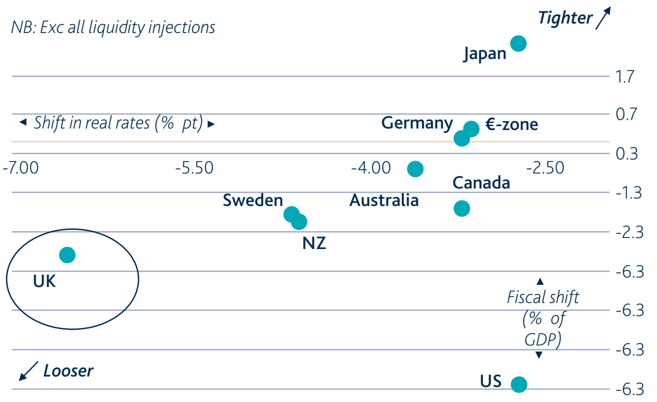
This leaves monetary policy as the pressure release. The BoE is putting as much store on tactics as medium-term strategy. We expect it to follow a slow rate-cutting path in pursuit of the "smooth Brexit" it craves. It will be wary of 'squandering' what ammunition it has (75bp of rate cuts, more QE) should Brexit threaten the system. But, if protectionism spreads, its hand will be forced, keeping liquidity plentiful. And, with the CPI again driven by cost not demand, the MPC will easily have fallen short of its 'Goldilocks' Bank rate of 2% during Carney's tenure, ending next February.

Economic & interest rate projections (p)

% yoy unless stated	'14	'15	'16	'17	'18	'19p	'20p
Real GDP	3.0	2.3	1.8	1.8	1.4	1.2	1.0
Household consumption	2.1	2.7	3.2	2.2	1.8	1.4	1.1
Fixed investment	7.3	3.4	2.3	3.5	0.2	0.4	0.2
Manufacturing production	2.9	0.0	0.3	2.6	0.9	0.3	0.6
Retail prices index	2.4	1.0	1.7	3.6	3.4	2.9	3.2
Consumer prices	1.5	0.0	0.7	2.7	2.5	2.2	2.6
Unemp, ILO rate (3m av, %)	6.3	5.4	4.9	4.4	4.1	3.9	4.1
Current account (% GDP)	-4.9	-4.9	-5.2	-3.3	-3.9	-4.3	-4.1
Gen budget balance (% GDP, FY)	-5.2	-4.1	-2.8	-2.0	-1.1	-1.3	-0.9
BoE Bank rate (yr-end, %)	0.50	0.50	0.25	0.50	0.75	0.75	0.25

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

Chart 10. No major economy has loosened policy more than the UK...
Shifts since 2000 in real rates (using 3m Libor, CPI), & cyc adj (2019e) budget balances

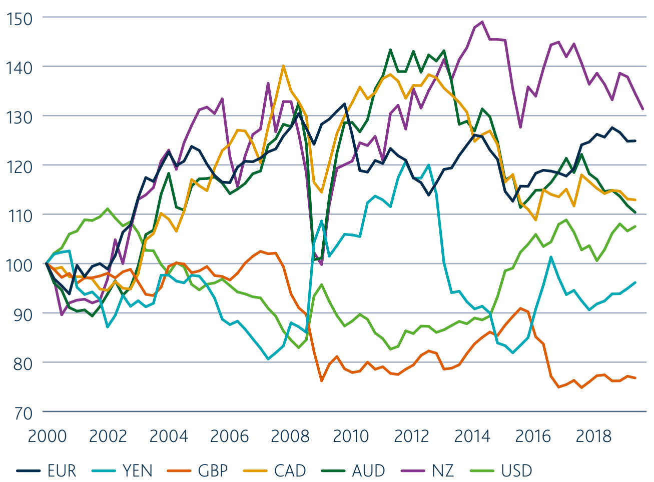


Source: Hermes Investment Management, based on OECD, & Bloomberg data

This equilibrium rate (r*), defined as that needed to deliver trend-growth and anchor CPI to its +2%yoy target, is hoped later to rise to 2-3%, as better productivity spurs wages and leveraging picks-up. Yet, the 'Holy Grail' remains real-wage growth, which had for the first time since the 1860s been squeezed for a decade. MPC members' assumption is that productivity – which has only flatlined since the crisis, delivering the UK's own 'lost decade' – begins to lift, justifying higher wage claims.

However, it's not guaranteed. BoE staff believe it takes four years for higher import prices to be fully passed on to a CPI basket that's about one-third imported. The shortfall – still apparent three years after sterling's dive – is presumably being felt in exporters' margins. This may not be reversed, even if Brexit is resolved quickly. Charts 10-11 remind us that, in the longer-term, no major economy has loosened policy more than the UK. Given the inflation premium, there's probably little coincidence the pound has underperformed. Which suggests little sustained upside for sterling after a relief rally, even when Brexit's cloud does start to lift.

Chart 11. Which helps explain the pound's longer-term weakness
Shows trade-weighted exchange rates, re-based to Feb 2000 (= 100)



Source: Refinitiv Datastream, based on central bank, & JP Morgan data

CHINA

Willingness of the PBoC to let the RMB slip below $/RMB7 for the first time since 2008 looks more a warning-shot to the US than this start of an aggressive devaluation. Admittedly, retaliation may increasingly be sought by inter alia a controlled currency softening, to claw back some competitiveness and stem China's slowdown. But PBoC's immediate concern is to avoid another haemorrhaging ($1trn between 2014 and 2017) of forex reserves, and retain at least some control of the currency, as individuals eat into their $50,000 per annum outflow limit. As a result, it's unlikely to allow main policy rates (thusfar unchanged) to fall as fast as money-market rates have, given still high leveraging and debt, and pressure on the renminbi.

Renminbi falls fastest during global influence…

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. This, plus growing protectionism as China's bilateral surplus with the US builds, (chart 12) suggest further RMB downside. Experience questions China meeting all the US's industrial, IP and technology conditions, raising the chance of a tariff of 10-30% on all China's US exports. In which case, China could extend its own 10-25% on $110bn of US imports to the remaining $20bn or so. This could be reinforced by cancellations of US agricultural orders, and increased regulation etc.

Harm to China and the US looks inevitable, however. RMB-weakening risks imploding China's corporate/banks' balance sheets exposed to USD debt. The PBoC would likely stem the fall by tightening capital controls and delving into its $3.1trn reserves. This would surely question China's commitment to buying US Treasuries (17% of international holdings), and, unless offset elsewhere (US QE?), would raise US mortgages typically priced off long yields. This has been a reassuring disincentive for markets – but, it may not prove a mutual deterrent.

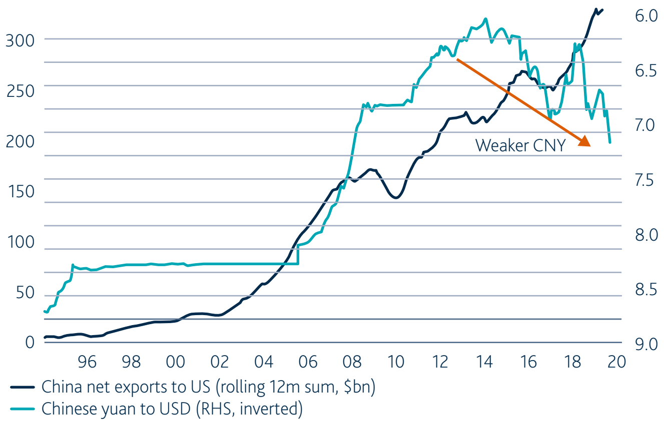
Onus will thus remain on China's traditional levers for keeping GDP close to target, including agricultural subsidies and infrastructure. Politburo sessions should reaffirm its growth objectives, with little more than 6%yoy now needed to have doubled 2010's GDP level and per capita income by 2020. These have been the core aims since 2015. Inflation (latest 2.8%yoy) may push up further on swine-fever affected pork prices (+27.0%yoy), but a +3%yoy headline CPI should remain only a "predictive target".

Fiscal policy may thus be loosened again, though there are early signs 2018-19's measures (manufacturing tax cuts, income tax reform) are arresting a slowdown hampered by 2017's credit tightening (chart 13). With growth since 2015 averaging 6.7%yoy, there's room later to address leveraging, debt, and shadow banking, and beef up the renminbi. But, during trade tensions, this looks remote. The impulse from allowing money rates last year to fall over 200bp has been reinforced by taking 350bp off banks' reserve requirements ratios. These cuts have looked obvious 'sweeteners' into US trade talks. But, they also aid SMEs again facing an upturn in real borrowing rates (chart 14).

So, an uneasy mix of currency depreciation, lower reserves, and selective defaults may prove 'damage limitation' for President Xi, who looks entrenched even beyond the twentieth National Congress in 2022. But, this will be much more presentable if he can blame it on the US!

Chart 12. PBoC will only reluctantly weaken the renminbi

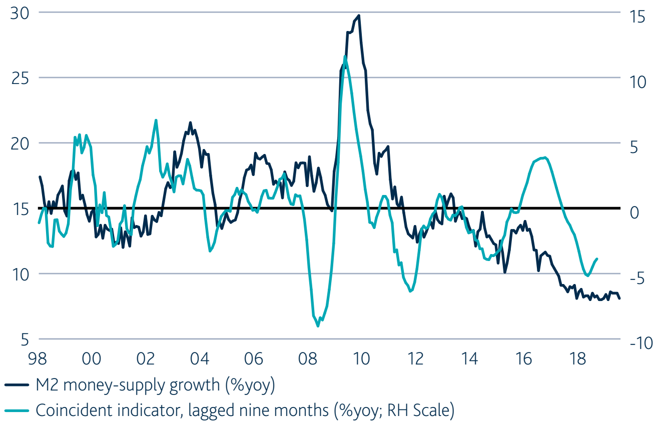
China/US bilateral trade surplus, 12m total, $bn. USD/CNY on an inverted axis



Source: Refinitiv Datastream, based on WM/Reuters, & IMF data

Chart 13. Stabilisation at lower activity rates?...

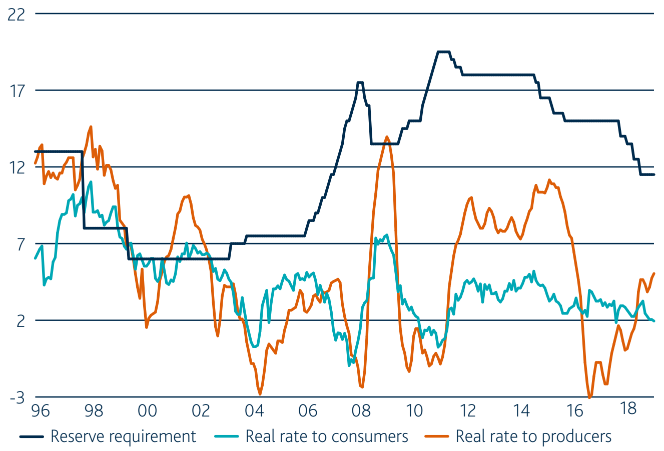
Shows coincident indicator lagged nine months, & M2 growth (%yoy)



Source: Refinitiv Datastream, based on NBS, & PBoC data

Chart 14. ...Offering more justification for a monetary loosening

China's 3-5yr lending rate deflated by CPI/PPI, vs RRR for small banks (all %)



Source: Refinitiv Datastream, based on NBS, & PBoC data

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