Outcomes beyond performance.

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Hermes Investment Office

Ahead of the curve

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

Tightening by doing nothing...

- **The US Fed remains the test case for whether central banks can ever 'normalise' rates. We expect it to try, but fail - peaking out at a far lower policy rate (1¼-1½%) than in past US recoveries.**
- **We update our 'Policy Looseness Analysis' to gauge how the US & UK's overall - monetary & fiscal - policy positions should shift into 2018. By taking explicit account of QE, true US & UK policy rates may be as low as -4¼% & -3% respectively.**
- **Running true rates this low would make the FOMC increasingly uncomfortable if at the same time the QE stock remains as bloated.**
- **Selling the assets back is admittedly one for later, & would have to be done gradually to minimise the disruption to bond markets. But, as a precursor, terminating the reinvestment programme would surely be the gentlest way of tightening - in effect by 'doing nothing'.**
- **It would help keep peak rates low, & give comfort that central banks are not falling 'behind the curve'. It may even go some way to reducing the downside of QE, evidenced by asset-price distortions, suppressed saving, & funding strains on many pension schemes...**

Pulling on the other lever?...

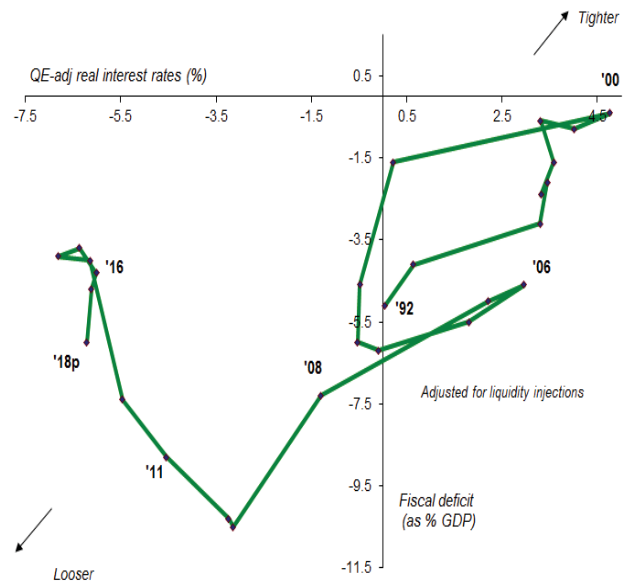
"...gradual increases in the federal funds rate would continue and...a change to the committee's reinvestment policy would likely be appropriate later this year". (FOMC minutes 5 April). *"The number of years we're thinking about*...to reduce the Fed's balance sheet to a more normal size...*is something like five years."* (John Williams, President, San Francisco Federal Reserve, 6 April 2017)

While markets continue to take a more than 'glass-half-full' view of the world, protectionism remains the new risk emerging. In the short term, reflation trades made sense, as speculation, rightly, that major economies will open the fiscal box lifted US equities to new highs, kept volatility around historic lows, raised inflation expectations, and questioned the durability of ultra-low government bond yields.

Yet, while better for growth, markets are ignoring the darker cloud looming. Rather than financial distrust, we may still need to brace for political distrust, with the threat of beggar-thy-neighbour policies - from the US to anti-European populism - rising. In which case, markets face a year of two halves, where stimulus-euphoria gradually

Chart 1. The US's macro policy mix, adjusted for QE

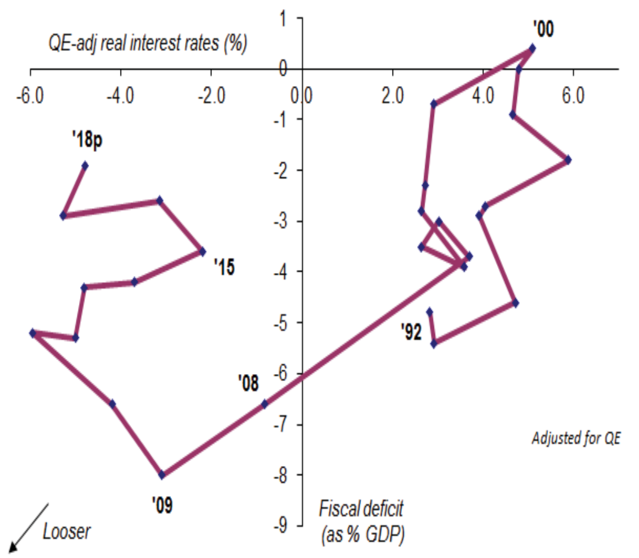
Using QE-adj Fed funds rate, core PCE, & cyclically-adjusted fiscal balance as % GDP



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

Chart 2. The UK's macro policy mix, adjusted for QE

Using QE-adj Fed funds rate, CPI, & cyclically-adjusted fiscal balance as % GDP



Source: Hermes Investment Management, based on OECD, OBR, & Bloomberg data gives way to stagflation concern. Helpfully, the trade-off, though, is that central bank policy rates stay lower than many expect.

Amid this, the US Fed remains the test case for whether central banks can ever 'normalise' rates. We expect it to try, but fail - hiking the funds target once or twice more, probably this September then possibly in another forecast-round in December. But, with cold winds elsewhere, especially in Brexit-tainted Europe, this would mean a peak of 1¼-1½% - way lower than the historic average of 5%. **We may thus face another two years of negative real rates, in the US and UK.**

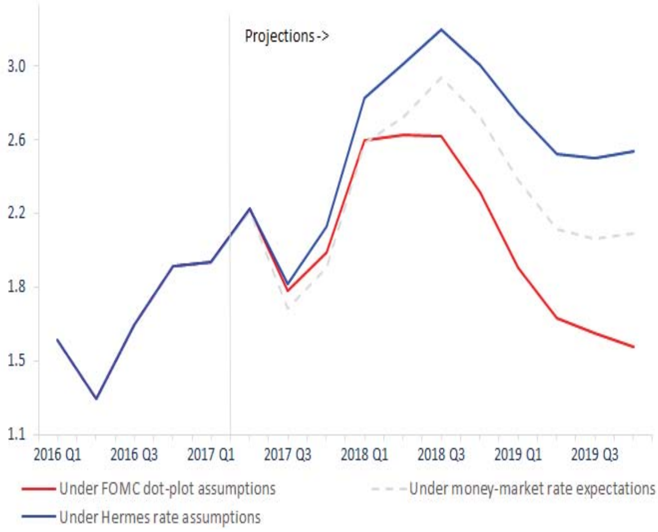
The easiest way to normalise monetary policy is surely to tighten by doing nothing

More worrying may be our increasing addiction to QE. As a result of their asset purchases, the world's big four central banks' balance sheets have in total ballooned to near $14trn ***(chart 3)***. This liquidity injection to the private sector is equivalent to three quarters of US GDP, or 1¼ times China's. And it means about one half of the world's $25trn global central bank assets has been amassed in just eight years. That is, after the last US (NBER-defined) recession ended in mid 2009. Early QE can be credited with unclogging the financial system in 2009, but it has since been a less-than-perfect remedy.

For one, it offers little to push productivity and wages, still the missing piece from most recoveries. One element behind the view of the FOMC's Brainard *et al* is that persistent excess capacity warrants a much lower 'neutral' (or 'Goldilocks') policy rate than in previous recoveries. **Encouragingly in the US, though, the presence of some productivity gain (+12% since the crisis) has helped average wages (+22%) beat the CPI (+15%).** By comparison, the UK's flat productivity has impeded wage growth (17%) relative to the RPI (+28%).

Part of this puzzle will be linked to disparate trends in worker participation rates. The US's shrinking labour pool doubtless underpins hiring difficulties/skills shortages at a time when unemployment (at 4½%) lies under the FOMC's 5¼-5½% NAIRU range. This should sustain the pick-up in wage growth needed to re-steepen the Phillips Curve, and keep some FOMC members alert to the inflation threat from sustaining negative real rates at 'full

Chart 4: Possible US growth profiles under different rate assumptions
Estimated GDP growth (%yoy) based on FOMC, market, & Hermes US rate scenarios

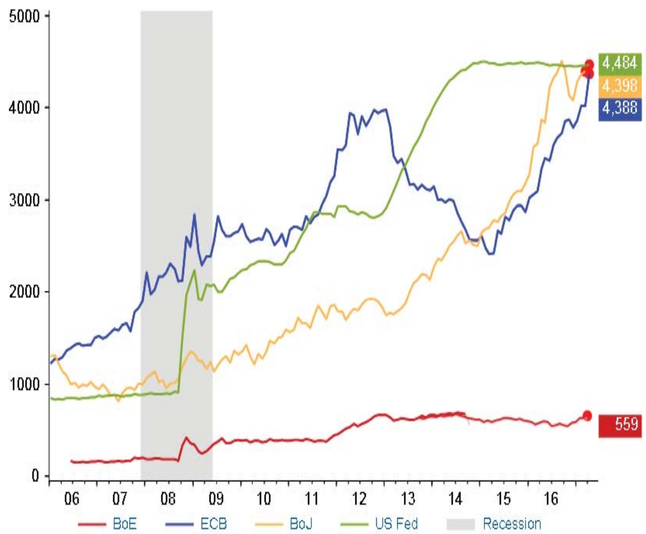


Source: Hermes simulations, based on BEA, & Bloomberg data, & Oxford Economics

employment'. By contrast, a steadily rising labour force in the UK (and the euro-zone and Australia) and the likelihood of the BoE having to turn a 'blind eye' on its single, *CPI* mandate as Brexit uncertainty persists, make a UK rate hike unlikely before 2018 at the earliest.

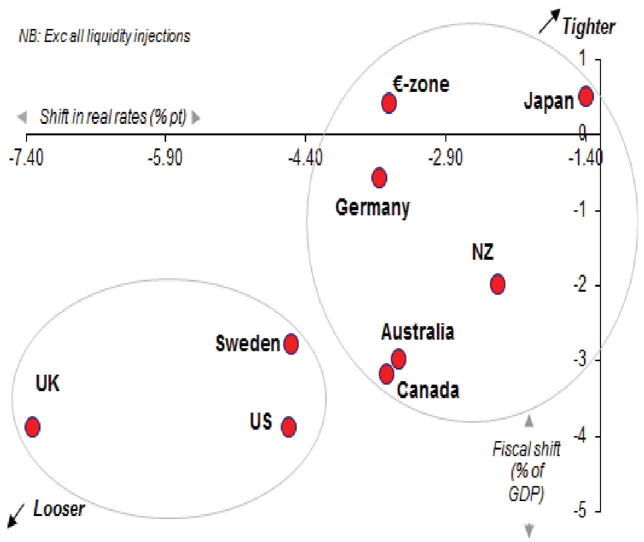
The US Fed, with its dual, employment and CPI mandate, thus stands out from others. As a guide, our simulations in ***chart 4*** show the possible US growth implications from further Fed hikes, ranging from our benign base-case of a *circa* 1¼% peak, to the 3% peak rate inferred from the FOMC's more hawkish 'dot-plot'. **This suggests that an FOMC determined to follow through on its current assumptions would *ceteris paribus* slice 1.4%point off cumulative GDP-growth over the next three years, relative to broadly leaving rates unchanged.**

Chart 3. Size of the main central banks' balance sheets
Central banks' balance sheets into and during QE (all $ bn). Grey is US recession



Source: Thomson Reuters Datastream, based on central bank data

Chart 5. No major economy has loosened policy more than US & UK...
Shifts since 2000 in real rates (using CPI, 3m Libor) & cyc-adj budget balances (2016)



Source: Hermes, based on OECD projections, IMF, & Bloomberg data

So, to do some of the heavy lifting and help achieve a low peak rate, the Fed could in tandem push on the other monetary lever: quantitative tightening (QT). Admittedly, after eight years of running QE, the challenge will be to ultimately sell back some of the assets without a sharp rise in US mortgage rates from higher long yields. **But, with the Fed and BoE believing the QE stock matters, a gentler, less visible tightening signal might be to allow it to erode naturally, by no longer reinvesting the proceeds of their maturing bonds. To avoid sharply higher yields, of course, even this may require 'forward guidance'.**

Adjusting for QE, nominal US & UK policy rates could be as low as -4¼% & -3%...

The main gains from US/UK QE have probably run their course. Consumers have benefitted from asset income, though, if aiding disproportionately higher earners, it has probably helped those that needed it 'least'. **But, it makes sense for lagging euro-zone and Japan to carry on with QE, using it to cap any rise in bond yields as they relax fiscally.** This impulse would go some way to aligning them with the US and UK whose macro positions have loosened the most ***(chart 5).*** **And, it's no coincidence that economies that have loosened the most experience in the longer term the weakest currencies *(chart 6).***

We update our 'Policy Looseness Analysis' to gauge how the US and UK's overall - monetary and fiscal - policy positions should shift into 2018. By taking explicit account of QE and fiscal positions, our analysis beefs up the 'Taylor Rule' the US Fed traditionally uses for setting rates. The Rule (without QE and fiscal considerations) currently pitches the Fed's target rate at 5% (its long-term average). **At 400bp above the Fed's current 0.75-1.0% range, those FOMC members targeting an unusually low peak rate seem, helpfully, to be ignoring their Rule.**

***Charts 1 and 2* summarise the results.** For the US, 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, which was at that stage just 0.25%. Extending this logic to the combined $4½trn QE since 2009 inferred about 550bp in total rate easing.

This has led to a *de facto* (QE-adjusted) *nominal* Fed funds rate now of about -4¼% - much lower than the 1% 'official' rate. This equates to an even lower, -6% real rate when we factor in the Fed's preferred core inflation target (core PCE), which it expects to average +1.9%yoy this year. Note ***charts 1 and 2*** plot these *real* (QE-adjusted) rates. **Running true rates this low would make the FOMC increasingly uncomfortable if at the same time the QE stock is being sustained.**

Chart 6: ...Which helps explain the USD & GBP's long-term weakness
Trade-weighted exchange rates, re-based to Q1 2000 (= 100). Quarterly data

Source: Thomson Reuters Datastream

Chart 7. In the long-term, central banks can keep peak rates down
Possible trade-offs between ultra-low peak rates & whittling down QE stocks (QT)

Market	Current policy rate (%)	Pref *long-term* peak rate?	Long-term average rate	Extra tightening required?	*Implication for *long-term* QT?
US	1.00% max	3.0% (e.g. Fed dot-plot)	circa 5.0%	+200bp	$1,600bn (= 36% of QE stock)
UK	0.25%	2.25% (e.g. Return to +ve real)	circa 5.0%	+200bp	£267bn (= 60% of QE stock)

*Derived from our Policy Looseness Analysis

Source: Hermes Investment Management, based on US Fed, & BoE staff simulations

Likewise for the UK, 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 £70bn announced after the Brexit vote) thus implies a UK policy rate of about -3%: much lower than the 0.25% official Bank rate.** Should Brexit's impact be contained, the MPC may get twitchy fingers in 2018.

***Charts 1-2* also illustrate how US and UK policy is evolving.** For the US, it reminds us how tight the stance was in the early 2000s dot-com boom, how expansionary it became after 2008, and that until last year, a sharp, growth-induced fiscal correction was underway. 2017's monetary stance is predicated on our assumption of another US rate hike to 1¼%; the Fed's core PCE expectation; and the OECD's projection of a 4.7%-of-GDP structural deficit. Key years are in bold. **2018 will be the tenth year of ultra-loose US monetary conditions, which the new administration is trying hard to supplement fiscally.**

Second, the UK *(chart 2)*, where policy tightening has been driven by attempts to take the structural deficit down to the OBR's 1.9%-of-GDP target, from 2.6% in 2016. And even the absence of further cuts in Bank rate after last August's reduction to 0.25% contributes to an even lower nominal rate of about -3% when we factor in QE. It falls also in real terms, to -5½%, as the CPI (set to average +2½%yoy in 2017) stays above the MPC's +2% medium term target, returning only in 2018.

Chart 7 goes a step further by gauging the extent to which the Fed and BoE looking to peak out at lower than 'normal' rates could pull on the other lever via QT. As an indication, ***chart 7*** takes as peaks the FOMC's 3% median expectation for after 2018, and for the UK an assumed goal of a positive real rate. These should be considered *maxima*. **In practice, the hit to growth could thus be minimised by in tandem winding down and/or selling over time a portion of their QE-bought bonds.**

***Selling* the assets is admittedly one for later, and would have to be done gradually to minimise the disruption to bond markets. But, as a precursor, terminating the reinvestment programme would surely be the gentlest way of tightening - in effect by 'doing nothing'. It would help keep peak rates low, and give comfort that central banks are not falling 'behind the curve'. It may even go some way to reducing the downside of QE, evidenced by asset-price distortions, suppressed saving, and increased funding strains on many pension schemes.**

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Hermes Investment Management

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Contact information

Hermes Investment Office

Eoin Murray, Head of Investment	+44 (0)20 7680 2802	eoin.murray@hermes-investment.com
Neil Williams, Group Chief Economist	+44 (0)20 7680 2398	neil.williams@hermes-investment.com
Chris Harvey, Director, Investment Risk	+44 (0)20 7702 6136	chris.harvey@hermes-investment.com
Daniel Nicholls, Head of Treasury & Centralised Dealing	+44 (0)20 7680 2194	daniel.nicholls@hermes-investment.com

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United Kingdom	+44 (0)20 7680 2121	**Africa**	+44 (0)20 7680 2205	**Asia Pacific**	+65 6808 5858
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