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Economic outlook

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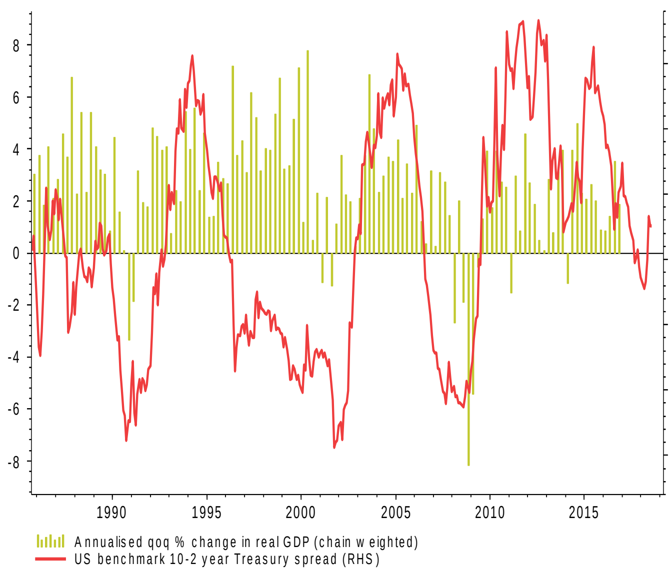
Beggar thy neighbour...

Main points

- Markets are taking more than a 'glass half full' view of the macro outlook, with little consideration of the new risk emerging. In the short term, this makes sense, as speculation, rightly, that major economies will open the fiscal box is sparking 'reflation trades'.
- Yet, while better for growth, markets are ignoring the darker cloud looming. Rather than financial distrust, we may 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 gives way to stagflation concern. Helpfully, the trade-off, though, is that policy rates stay lower than many expect.
- The impact of protectionism this time could be far more complicated than in the 1930s. First, the economic & financial linkages suggest the knock-on would be more far reaching. Global retaliation would activate second-round effects that later offset the initial growth-impulse from Mr Trump's tax cuts.
- Second, the deflationary return to the US could thus be much larger than anticipated. China's commitment to US Treasuries would be questioned, supply chains for US corporates disrupted, & the US's already shrinking labour supply & potential growth reduced further.
- Third, should protectionism build, inflation will reappear. But, with the possible exception of the US, it'll be the 'wrong sort' – cost, rather than demand-led. Central banks will 'turn a blind' eye as economies stagflate, so the inflation flame may snuff itself out.
- And, this comes *on top of* monetary expansion. Central banks still daren't lift the tide of liquidity hiding the sharp rocks beneath. Real rates will stay negative, with peak rates lower, & central banks unable to turn off their taps without unintended consequences.
- In which case, 'lower for longer' will continue. And, chasing the 'great rotation' of an *en masse* shift out of bonds means taking on the central banks. So, the quest for yield - even in 2018, ten years after the pit of the crisis - will persist...

Chart 1. Expectations are high that US growth can be sustained...

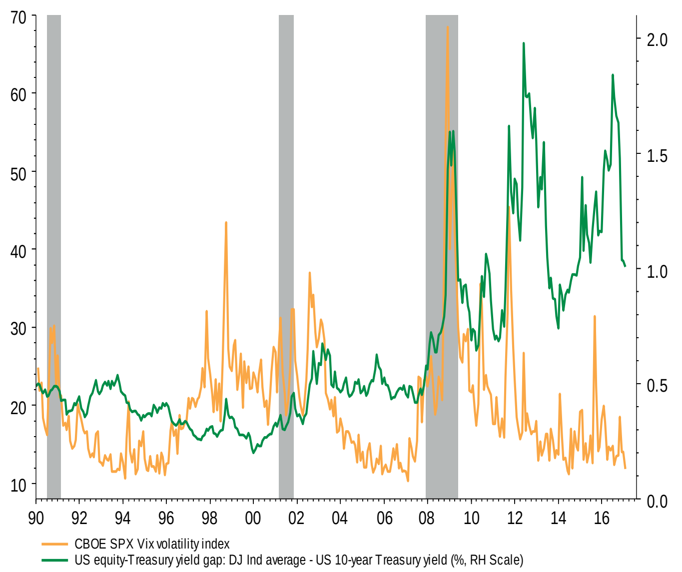
US GDP growth with six-quarters lag, &10-2-year US Treasury note spread, bp



Source: Hermes Investment Mgmt, based on BEA, & Thomson Reuters Datastream

Chart 2. ...Helping to lift already supported equity markets...

US equity-bond yield gap (using Dow Jones Industrials & 10-yr USTr), vs Vix volatility index



Source: Thomson Reuters Datastream

Comment

Markets are taking more than a 'glass half full' view of the macro outlook, with little consideration of the new risk emerging. In the short term, this makes sense. Speculation, rightly, that major economies will open the fiscal box is causing 'reflation trades' to lift US equity indices to new highs, keep volatility around historic lows, raise inflation expectations, and make the 30-year bull-run in government bonds look staler *(charts 1-2)*. Yet, while better for growth, markets are ignoring the darker cloud looming. Rather than financial distrust, we may 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 gives way to stagflation concern. The trade-off, though, is rates stay lower than many expect.

The impact of protectionism could be far more complicated than in the 1930s...

Without care, an unhelpful jigsaw piece from the 1930s - retaliatory trade protectionism - might come crashing into place. In 1930, it was triggered by the Smoot-Hawley (S-H) reforms that raised US tariffs to up to 20% on over 20,000 imported goods. This impacted the US's relatively smaller number of trading partners (predominantly Canada, Europe), and prolonged the depression. 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, on countries deemed (by him) to be engaging in *"unfair"* trade practices against the US.

The impact this time would be more complicated. **First, economic and financial linkages suggest the knock-on would be more far reaching.** Central to our US growth projections *(page 3)* is that retaliation - may it be tit-for-tat tariff rises, qualitative barriers and/or competitive currency depreciations - would activate second-round effects that later offset the growth-impulse from Mr Trump's tax cuts. A strong dollar would reinforce this. **In 1930, Canada retaliated even before S-H became US law. Britain and France sought new partners, and Germany moved to autarky.** Canada then forged closer links with Britain - an early precedent to the tariff-free EU deal it signed last year. The UK *(page 6)* may now have to negotiate something similar.

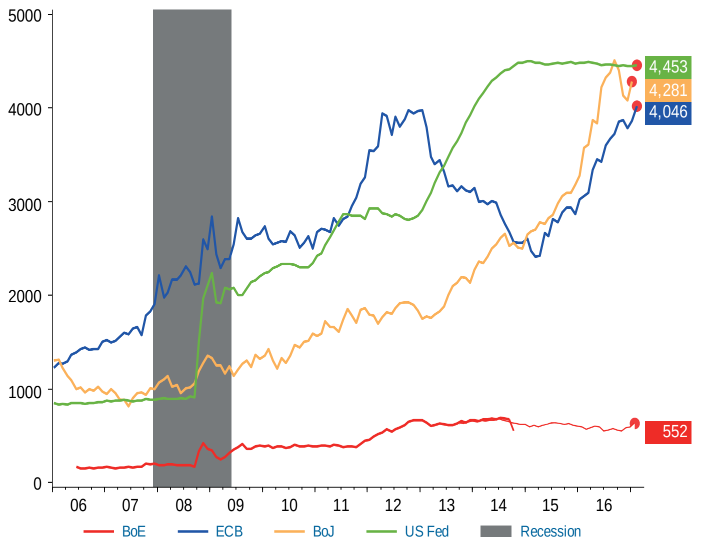
The broader mix of countries affected would doubtless include the emerging markets whose 'cheaper' imports then fill the gap. Especially heavy may be the hit to Mexico (which relies on the US for 80% of its exports and the bulk of remittances), and Canada as NAFTA unwinds. China would react by devaluing its currency more aggressively than the 6-7% fall implied by forwards for two years time. This would spark competitive depreciations elsewhere (*e.g.* S.E. Asia),

Second, the deflationary return to the US could thus be much larger than anticipated. A renminbi devaluation that hurt China's own balance sheets would question its commitment to US Treasuries just as the US budget deficit is widening. And, on a micro level, the threatened 35% and 45% tariffs on Mexico and China would surely disrupt US car manufacturers' own supply chains from Mexico, and the ability/cost of US companies' outsourcing their IT production to China. Setting up chains elsewhere may be more difficult/costly in a protectionist world.

Also, ring-fencing Mexico and lifting the deportation of undocumented immigrants would further shrink the labour pool. The US participation rate, already close to a 36-year low, is contributing to hiring difficulties and skill shortages. **It also risks an element in short supply in the US's eight-year expansion: potential growth.** The NBER estimates these immigrants contribute 3% of private-sector GDP. Yet, by accounting for 9% of agriculture, construction and leisure-sector value added, their relatively low skilled, low pay jobs may not offer *widespread* appeal.

Chart 3. But, chasing a 'grand rotation' means taking on the central banks

Size of central banks' balance sheets into and since QE (all $bn). Grey is US recession



Source: Thomson Reuters Datastream, based on central bank data

Third, should protectionist forces build, which seems likely, inflation should reappear. But, with the possible exception of the US facing labour shortages, it will be the 'wrong sort' – cost-push, led by tariffs, weaker currencies, and goods shortages, rather than demand-pull. Central banks will thus 'turn a blind' eye as economies stagflate. This portends more to the inflation rises of the early 1980s and 1990s recessions, than the overheating of the late 1980s and 2007. **In which case, the inflationary flame may snuff itself out without policy action.**

But, this comes on top of, not instead of, monetary expansion. Nine years after the first traces of crisis, and central banks daren't lift the tide of liquidity hiding the sharp rocks beneath. With policy rates staying close to the floor, 'loose for longer' probably has years left to run. We still have a two-speed recovery, with the US and UK leading. Yet, even there, where central banks consider neutral (or 'Goldilocks') rates to be much lower, real rates will stay negative. And, 'peak' rates will end up much below what we're used to (we expect about 1% in the US).

The question after eight years of QE totalling $13trn is how central banks can turn off the liquidity taps without unintended consequences. We expect them to continue, with 'their skin in the game' via bloated balance sheets suggesting they cannot take us off guard ***(chart 3).***

For other emerging markets, the outlook in a more protectionist, strong USD scenario is less rosy. China, cornered by an overheated housing market, would put currency slippage ahead of rate cuts (page 7). Clear vulnerabilities exist, such as those non commodity-exporting sovereigns with high exposure to short-term USD debt and foreign saving needs, including Latam, Ukraine, S. Africa, Turkey. Thankfully, for most others, external debt-ratios are lower, with fewer currency pegs to protect. And, where domestic debt climbs, they can run QE.

In which case, while reflation trades look appropriate at the start of 2017, the spectre of political disruption, increasing protectionism, cost inflation, and dissipating growth mean 'lower for longer' will continue. And, chasing the 'great rotation' of an *en masse* shift out of bonds means taking on the central banks. So, the quest for yield - even in 2018, ten years after the pit of the crisis - will persist.

United States

We continue to expect Mr Trump's (first) term to be one of two halves, where the initial stimulus from his proposed fiscal splurge becomes increasingly muted by the threat of widespread protectionism, and possible USD strength on repatriation. With some of his fiscal and immigration proposals looking extreme, he may in time have to water them down to get approval from a relatively more conservative Congress. But while generally limiting his ability to impose 'wildcard' fiscal measures, Congress may not be able to preclude his more protectionist trade stance. In which case, renewed volatility may blur the path for US rates. But, it still doesn't point to an aggressive Fed, making the FOMC's projected 3% peak rate look unrealistic.

Mr Trump's term could be a period of two halves, as stimulus turns to stagflation...

The President's first visible macro test will be to raise the $18.1trn debt ceiling on 15 March, which sets the theoretical cap on government financing. Central to his tax-cutting pledges will be surely to pass it, especially as fresh commitments have since unofficially breached it, to $20trn. But, unless dealt with effectively, the threat of government shutdown, unpaid obligations, and 'default risk' would spook markets that prior to the election were predicting a recession by the 2018 mid-terms ***(chart 1)***. 'Default' is likely only via inflation, yet if akin to previous shutdowns such as August 2011, equities would suffer.

Admittedly, with GDP growth running at a fair clip (about 2%yoy, and 2¼% ex-government), and the real GDP *level* up 13% on its pre-crisis peak, the short-term outlook remains constructive. Mr Trump advocates across-the-board individual/business tax cuts and consolidation skewed toward higher earners, increased infrastructure spending, yet reductions to immigration and trade partly through border-tax adjustments. **Taken literally, this infers a hit to tax revenue of about $4trn (22% of GDP) over two terms, only part financed by spending cuts.** Congress would likely push back on this.

It may also oppose his aggressive 45% and 35% tariffs on China and Mexico, and review of NAFTA. **But, he could still invoke 'Super 301' (section 301 of the 1974 Trade Act) to impose tariffs without Congressional or WTO approval, on countries deemed to engage in *"unfair"* trade practices.** In which case, expect a broadening out to other countries (e.g. emerging markets) whose 'cheaper' imports

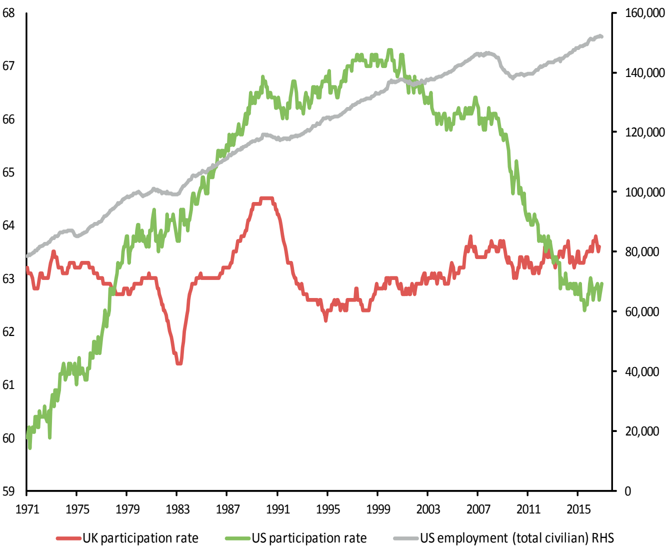
Economic & interest rate projections (p)

% yoy unless stated	'12	'13	'14	'15	'16	'17p	'18p
Real GDP	2.2	1.7	2.4	2.6	1.6	2.5	1.6
Personal consumption	1.5	1.5	2.9	3.2	2.7	3.2	2.2
Business investment	9.0	3.5	6.0	2.1	-0.4	3.0	1.6
Industrial production	2.8	1.9	2.9	0.3	-0.9	2.0	1.8
Consumer prices (nsa)	2.1	1.5	1.6	0.1	1.3	2.5	1.9
Unemployment rate (%)	8.1	7.4	6.2	5.3	4.8	4.6	4.4
Current account (% GDP)	-2.8	-2.2	-2.3	-2.6	-2.6	-2.8	-2.8
Fed budget balance (% GDP)	-6.5	-3.3	-2.8	-2.6	-3.1	-3.5	-3.4
Funds target (yr-end, %)	0.25	0.25	0.25	0.50	0.75	1.00	1.00

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

Chart 4. US labour participation is still close to a 36-year low

US & UK participation rates (labour force as a % of working age population)



Source: Thomson Reuters, based on BLS, & ONS data

then fill the gap. **Global retaliation might follow, with a stronger-than-hoped-for deflationary flow-back to the US.** So, after the initial boost, US growth could slow again, offering a weaker footing to an economy having potentially to weather a correction in asset prices.

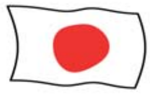
Mr Trump's threats also to ring-fence Mexico, and increase the deportation of undocumented immigrants (11.3 million over two terms) would, unless offset, accelerate the shrinking labour supply. This is akin to 7% of the workforce, or three to four times the maximum achieved *per annum* under President Obama. **This threatens the main element in short supply during the US's official (NBER-defined) eight-year business expansion: stronger potential growth.**

The OECD expects US potential growth to be just 1½% in 2017 and 2018 - below the current growth rate. And FOMC doves like Brainard argue that overcapacity warrants a much lower 'neutral' policy rate than past recoveries. Encouragingly in the US, though, the presence of some productivity gains (+10% since the crisis) has helped average wages (+22%) beat the CPI (+15%). By comparison, the UK's flatter productivity has impeded wage growth (15%), relative to the RPI (+27%).

Part of this puzzle is still linked to disparate trends in worker participation rates. The US's unemployment fall has been widespread, but, the labour pool is shrinking ***(chart 4)***. This is keeping the worker participation rate close to a 36-year low, contributing to hiring difficulties and skills shortages at a time when unemployment, at 4.8%, lies easily under the FOMC's 5¼-5½% NAIRU range. This is in contrast to steadily *rising* labour forces in the UK, euro-zone and Australia.

A further cut to the labour pool could spur wages. Yet, the hit to consumers and firms from the cost-push inflation that protectionism spawns suggests any demand-lift from higher wages and a more isolationist US could be short-lived. **In which case, the FOMC may be more reluctant to hike than markets, expecting a hawkish, Trump-nominated replacement for chair Yellen next February, assume. And especially if the dollar's ascent tightens policy for them. Otherwise, the US's eight-year expansion - its third longest so far from trough to peak - may not in summer 2019 become its longest ever.**

Japan



Despite his strengthened position, PM Abe still has every incentive to accelerate growth, and rekindle an inflation rate that's fizzled out. By boosting last July its hold on the Upper House, his LDP/ Komeito coalition now holds a two-thirds 'super' majority in each chamber, thereby fulfilling two of the three requirements for Japan's most widespread constitutional change since 1947. The other being a referendum, which if passed clears the way for his long-held desire to review Article 9 that denounces war as a means of settling international disputes. By effectively securing his position out to December 2018's Lower House election, Abe should beat Koizumi's record in 2001-06 of staying in office for five and a half years. He could meanwhile call a snap election to capitalise on opposition weakness.

Abe has fulfilled two of the three requirements for constitutional change...

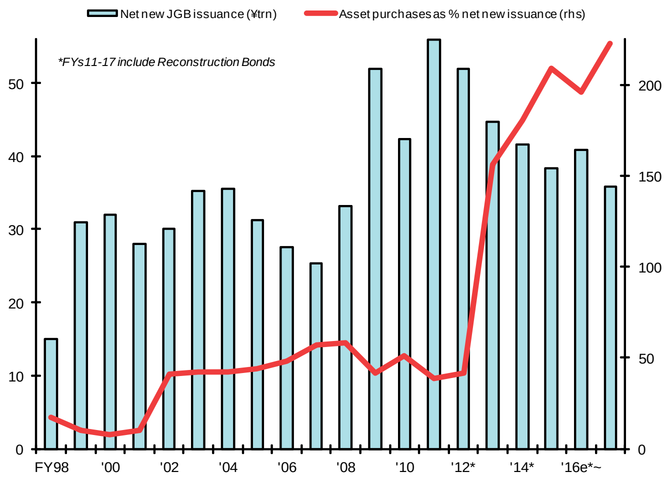
Abe's three-arrow macro strategy - of a looser monetary stance, expansionary fiscal stimulus, and longer-term structural reforms (labour market, corporate governance) - will continue. But, they may fail to defeat deflation once and for all. After 18 years of monetary expansion, payback has been limited. The BoJ has for a year been targeting explicitly a zero 'yield' on 10-year JGBs. But, it has disappointed by not expanding its tiering of negative policy rates, currently centred on a 0.1% charge on banks' newly created reserve balances. This is small, and leaves the larger, existing portion 'attracting' 0.1%. Governor Kuroda's scepticism just before the move and the BoJ's slender 5-4 vote smell of political pressure.

As does the BoJ extending to FY2018 (year starting April 2018) its pledge to hit the +2%yoy CPI target. Postponement helped Abe win last July's election, and the latest delay (the fourth) takes pressure off Kuroda before his term expires in April 2018. **Further yen weakness on any US protectionism/repatriation would help. But, BoJ rates might have to be cut again if the yen then receives unwelcome support from Brexit, and an early end to the Fed's rate-tightening policy.**

In addition, the fiscal lever will be pulled again. Last September's ¥13½trn ($121bn) 'real water' spending-expansion on infrastructure, SMEs, and the lower-income end has had limited impact. Yet, with Japan already running the developed world's highest government debt-to-GDP, at 240%, the BoJ daren't cut back on QE. At ¥80trn *per annum* of total asset purchases (the vast bulk being JGBs, the rest being ETFs and REITs), it's mopping up JGBs at almost twice the pace of net supply (¥41trn). The BoJ has under Kuroda doubled its share outstanding to 45%, which leaves private institutions chasing riskier assets and/or looking overseas for bonds to buy, helping to soften the yen.

Chart 5. The BoJ will have to mop up even more JGBs

Net new JGB issuance (¥trn), vs BoJ's total asset purchases as a % of JGB issuance



Source: Hermes, based on MoF, & BoJ. (~NB: FY16 & FY17 assume unchanged rate of QE)

Encouragingly for debt ratios, the *level* of nominal GDP is 8% higher under Abe, driven by mild price gains (using the GDP deflator). **So, by maintaining a nominal *growth rate* (currently about 1%yoy) above the average long-term interest rate, the MoF hopes to carry on borrowing without raising the debt ratio. But, this catch-22 precludes the BoJ from switching off, or even reducing, its QE *(chart 5)*.**

And, meantime, *real* GDP (for so long boosted by deflation) is flatter, and likely to no more than zig-zag. It was slow to rebound from a sharp drop in Q2 2014, initiated by the sales-tax rise, from 5% to 8%. Little wonder the second leg of the tax rise, to 10%, is deferred to October 2019. It may yet be abandoned. An important consideration is land prices, which only in 2015 started to stabilise. Falling land prices was the common link when the MoF raised the sales tax in 1997, from 3% to 5%, and the BoJ in mid 2000 prematurely ended its zero rate policy. Each time, they had to back-track as consumption slumped.

Yet, while helpful, this together with previous deferrals and a corporate-tax cut, from 32% to 29%, postpones fiscal consolidation. Specifically, the tax-hike postponement foregoes a proportionate lift to the CPI, and its contribution to the hoped-for ¥12½trn (2% of GDP) revenue lift from the two hikes together. **Without plugging this tax-revenue gap, the deferral probably rules out Abe's aim of striking a primary surplus by FY20 - even with the Rugby World Cup and Tokyo Olympics.**

The other missing link is wage growth. Our Phillips Curve analysis 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, last spring's annual wage-round (*shunto*) was tame, with the +2.1%yoy average, one-off wage hike no higher than 2015's. These were not sustained, and political pressure on firms to raise wages will continue to build in FY17.**

Economic & interest rate projections (p)

% yoy unless stated	'12	'13	'14	'15	'16	'17p	'18p
Real GDP	1.5	2.0	0.3	1.2	1.0	1.0	1.3
Private consumption	2.0	2.3	-0.8	-0.4	0.4	0.6	0.7
Business investment	4.2	3.8	5.0	1.2	1.0	1.2	1.8
Industrial production	0.2	-0.6	2.1	-1.2	-0.2	1.6	2.2
Consumer prices	0.0	0.3	2.7	0.8	-0.1	0.5	1.0
Unemployment rate (%)	4.3	4.0	3.6	3.4	3.1	3.0	2.9
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	-6.4
BoJ target rate (yr-end, %)	0.10	0.10	0.10	0.10	-0.10	-0.25	-0.25

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

Euro-zone

While helpful in addressing the *symptom*, deflation, Mr Draghi still cannot be expected to solve the underlying *problem* - a monetary union devoid of economic union. This will take years. With this in mind, we update our *Competitiveness Analysis* to show the progress so far. We use the OECD's estimates to the end of 2016 and projections to 2018 of a country's unit labour costs in tradeable goods, relative to its main trading partners' (RULC). The average is weighted, then indexed to a 2010 base year (=100). A rising index indicates a *de facto* real effective exchange rate appreciation and falling competitiveness. An index fall signifies the opposite. The results are in ***chart 6***.

The euro-zone's competitiveness gap is narrowing, but will take years to close...

First, as an amorphous bloc, the euro-zone is after six years of austerity regaining competitiveness lost since the euro. Only part of this can be laid at the weaker euro's door (-15% in trade-weighted terms). The zone's costs between 2000 and 2009 rose a net 21% relative to its trading partners. This compared with *falls* of 19% in both the US and UK. Yet, since austerity started in 2010, its costs have fallen back 7%, beefing up a current account surplus helped by oil. This beats a currency-induced rise of 20% in the US and the UK's 3% fall. If sustained, it suggests further relative gains in euro-zone exports.

Yet, despite this *overall* improvement, shifts in *individual* members' competitiveness are still too disparate. *Chart 6* shows the absolute competitiveness-shifts by country from 2000 to 2016. With the escape route of currency devaluation closed off, the deciding factor has been whether members undertake the internal, cost adjustment needed to boost competitiveness, thereby generating GDP and tax revenue. **On this basis, the biggest winners still include Germany, which is helpful given it accounts for about 30% of euro-zone GDP.** Germany saw its unemployment rate rising from under 8% in 2001 to over 11% by 2005. But, this reaped dividends, and it has since translated cost control into substantial current account improvement.

By contrast, most other members have experienced a deterioration. Because of its adjustment, Germany has managed to cut its RULC by 9%. But, countries on the right-hand side of ***chart 6*** saw theirs climb. Up to 2010, Spain and Italy's competitiveness deteriorated fastest. Ireland and Greece had to suffer deflation to 'improve' their position.

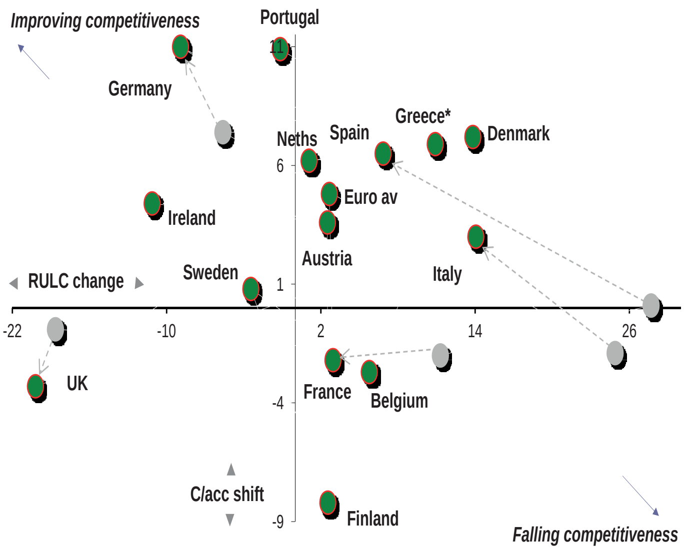
Economic & interest rate projections (p)

% yoy unless stated	'12	'13	'14	'15	'16	'17p	'18p
Real GDP	-0.9	-0.2	1.2	1.9	1.7	2.0	1.6
Private consumption	-1.2	-0.5	0.8	1.7	1.9	2.0	1.7
Fixed investment	-3.3	-2.5	1.4	2.9	2.7	2.5	2.2
Industrial production	-2.3	-0.7	0.9	2.0	1.4	1.6	1.5
Consumer prices (HICP)	2.5	1.3	0.4	0.0	0.2	1.4	1.7
Unemployment rate (%)	11.4	12.0	11.6	10.9	10.0	9.6	9.3
Current account (% GDP)	1.3	2.2	2.4	3.0	3.2	2.9	2.8
Gen budget balance (% GDP)	-3.6	-3.0	-2.6	-2.1	-1.8	-2.2	-2.3
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. Competitiveness within the euro-zone is still too disparate

Change from 2000 in RULC, vs c/acc shift. Arrows denote shift since austerity in 2010



Source: Hermes Investment Management, based on OECD data (*Greece is from 2001)

But, Spain and Italy's deterioration is now correcting, and their shortfall versus Germany reducing *(chart 6)*. We highlight the 2000-2010 period by the grey blobs, to highlight progress since austerity. The estimates to 2016 in green thus suggest improvement. **Outside the zone, the UK since 2000 has managed to outperform by virtue of sterling's 23% depreciation - a route cut off to euro-zone members.**

But, this comes at significant economic and social cost, suggesting additional stimulus is needed. First, lower trade flows and the drain on resources risk holding back the 'core' members. Germany's competitiveness is improving, but may be tested if its euro peers (40% of Germany's exports) can't make up for a slower China/Russia etc.

Second, boosting competitiveness via austerity poses its own risks. The difficulty is raising competitiveness via productivity, rather than higher unemployment, falling wages and/or *slashing* taxes that governments can't afford. Though reaping the benefit now, deflationary Ireland in 2009-10 suffered the vicious circle of bloating real debt, lower ratings, higher funding costs and recession, exacerbating the deflation.

And, after impressive gains, there's a limit to how far Spain and Italy can reform, given male youth unemployment rates of 43% and 36%. Their real household spending are still 4-7% down on 2008, yet Germany's is 10% up. Then there's Greece, whose deflation improved competitiveness, but exacerbated its real-debt dynamics. Without debt relief, its €86bn package is only a 'sticking plaster'. After losing 30% of real GDP since 2010, it too has reform fatigue.

So, tackling the *cause* of the problem always needed more than just QE. Its effectiveness hinges on capping long rates, helped by the ECB's latest commitment to buy bonds to a yield even *lower than* the deposit rate. This *should* further stimulate consumption, with roughly two-thirds of euro-zone private borrowing (personal and corporate) long-rate, rather than short rate, driven. This is the mirror image of the UK. **So, meanwhile, with 2017 being such a highly-charged political year in Europe, any contagion - unlike 2008 - is more likely to be political rather than financial. And, with the monetary engine already overloaded, it looks time to also crank up the fiscal side.**

United Kingdom

Explanation of the Brexit process and The Supreme Court ruling lift much - but not all - of the uncertainty facing investors. They confirm that after nine months in the 'departure lounge', Article 50 should be triggered in late March to start negotiating the exit. Officially, no other countries' membership models will be sought, which seems to rule out Norway and Switzerland's associate memberships. Yet, PM May's desire to *"pursue a bold and ambitious free trade agreement"* with the EU suggests she may yet negotiate to maintain access to - but no longer full membership of - a tariff-free system (akin to Canada's) and/or a customs union (similar to Turkey's).

Governor Carney's 'blind eye' would be akin to King's when the CPI breached 5%

But, the negotiations could stretch well beyond the two years assumed by Article 50. First, the deal when struck needs Parliamentary approval after input from devolved governments in N. Ireland, Scotland, and Wales. It will then be subject to a 'phasing in' period (Mr Hammond suggests two years) to allow firms, consumers and officials to adjust to the arrangements. A second independence referendum in Scotland, though not precluding Brexit, could provide an extra hurdle to completing it before the General Election by May 2020.

Second, the UK is relying on a cooperative sign-off by its 27 EU peers. The only real precedent we have is Greenland's exit' in 1985. This was a 'soft' exit, but it took three years with negotiation centred on just one main issue: fishing rights. We, larger and 44 years entwined in the EU, will need longer. Unless, of course, EU leaders perceive the potential spillover to be so strong that it brings forward an early 'suits-everyone, no strings' compromise deal. **The risk to this 'grown up' approach, though, is having delivered exit-risk onto the doorsteps of other EU governments, themselves vulnerable to rising anti-establishment feeling, the UK receives little sympathy from them.**

Third, EU law forbids trade-deal 'bigamy', in terms of enacting agreements elsewhere while still an EU member. This prevents quick tie-ups with say the US. **So, a challenge is to remain close to the European 'table' to maintain the best trade/regulatory deals for services.** This makes it more ambitious than a Canada-type deal. Services are 80% of UK gross value added, compared with 50-60% in Germany and France, and have been the heartbeat of the recovery.

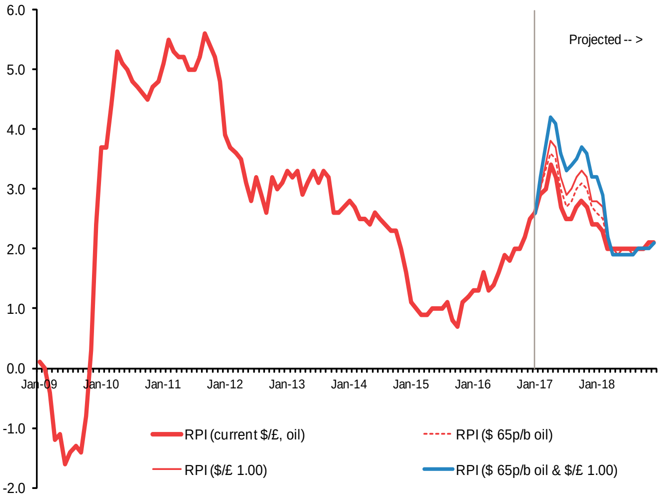
Economic & interest rate projections (p)

% yoy unless stated	'12	'13	'14	'15	'16	'17p	'18p
Real GDP	1.3	1.9	3.1	2.2	2.0	1.5	1.2
Household consumption	1.8	1.6	2.2	2.4	2.8	2.0	1.4
Fixed investment	2.4	3.2	6.7	3.4	0.5	-1.0	-2.0
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	2.8	2.1
Consumer prices	2.8	2.6	1.5	0.0	0.7	2.3	1.8
Unemp, ILO rate (3m av, %)	8.0	7.6	6.3	5.4	4.9	5.1	5.3
Current account (% GDP)	-3.7	-4.4	-4.7	-4.3	-5.0	-4.3	-3.3
Gen budget balance (% GDP)	-7.3	-5.9	-5.0	-4.0	-3.5	-2.9	-2.2
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. Possible RPI-impact if Brexit further weakens the pound

Simulations based on possible $/£ & oil scenarios. Assumes no further rate changes



Source: Hermes Investment Management simulations, based on ONS data

Which leaves the BoE watchful that a weaker pound doesn't pump inflation, especially with the main activity data having held up since June's referendum. Should protectionist forces build, inflation will reappear. But, it will be the 'wrong sort' – cost-push, led by tariffs, goods and labour shortages, 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 2007. In which case, the inflationary flame may snuff itself out without BoE action.**

Our simulations in ***chart 7*** show at current USD/GBP and oil prices RPI inflation this April lifting to +3.4%yoy from January's +2.6%yoy. But, combinations of a weaker pound and/or higher oil could feasibly take the RPI past +4%yoy. This would be a five-and-a-half year high. In each case, the CPI (not shown) breaches its +2%yoy target from March. Further GBP weakness and oil strength would lift it through +3.0%yoy. But, we still doubt the MPC would react, given the hit to growth.

Governor Carney's worry seems to be the *"extent to which"* it breaches target, rather than the breaching itself. **This would be akin to the 'blind eye' governor King turned in 2011 when the CPI climbed to +5.2%yoy as the pound weakened and energy/food prices rose.**

Helpfully for growth too, the Treasury no longer aims to return the public finances from 'red to black' by 2019/20. An underlying balance is targeted now for 2022/23. And, with lower-than-planned tax revenue since the 2016 Budget and softer GDP assumptions, Brexit savings (£8-10bn p.a.) are not enough to counter the £122bn extra borrowing over five years. This amounts to about 5% of GDP. **After, adjusting for special factors such as QE proceeds and the transfer of RMPP, Mr Hammond's plans look far looser than his predecessors'.**

This has further implications for the pound. No major economy has longer-term net loosened its overall (monetary and fiscal) stance more than the UK. And, given the subsequent inflation premium, there's little coincidence that those running expansionary policies like the US/UK have generally sustained the weaker currencies. **So, the prospect for UK policy to stay loose, Brexit negotiations stretching beyond the two years, and USD strength, should leave the pound vulnerable, and the main 'barometer of progress' as the exit talks get underway.**

China

Imposing capital controls and allowing money rates to drift up look targeted at stemming capital outflows and avoiding disruption ahead of President Xi's Politburo reshuffle this autumn, rather than the start of an aggressive policy tightening. They also send a signal to the banks to rein in credit expansion, as the PBoC grapples with its dilemma of supporting growth yet cooling an overheating housing market. There, affordability in the main cities, has deteriorated faster than in other world centres *(chart 8)*. But the immediate concern is to halt a $1trn haemorrhaging of forex reserves since 2014, and take back some - if only temporary - control of the renminbi, as individuals again start eating into their $50,000 *per annum* outflow limit.

Higher rates aimed at stemming outflows, rather than starting aggressive tightening

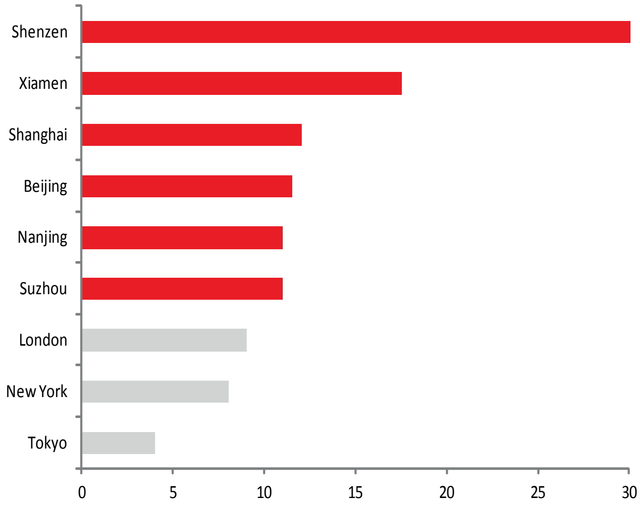
Politically, this, plus PBoC's various interventions since 2014 to *contain* the CNY/USD's depreciation - including its new trade-weighted basket - water down for now accusations of it being a downward currency manipulator. **Within China's trade data, the net effect since 2014 of declining hard currency supplied by exporters (especially) and that demanded by importers broadly tallies with the fall in reserves.** While consistent with a slimmer current-account surplus (2.4% of GDP in 2016 from 3% in 2015), the apparent shift in currency preference away from RMB seems to lie behind much of the recorded outflow.

Last November's controls (SAFE vetting of overseas transfers, scrutiny of foreign acquisitions, monitoring of cross-border flows through Shanghai, suspended issue of dual-currency credit cards) should slow the rate of depreciation in coming months. **But, renminbi depreciation is likely to remain the authorities' preferred pressure release as they grapple with slower growth, external headwinds, and, technically, the new currency basket, where adjustments are made against other currencies to compensate for USD swings.** Especially as individuals start reaching their $50,000 annual outflow limit.

Since refixing the peg in August 2015, the RMB/USD has fallen to an eight-year low. And, tellingly, it's been allowed to fall fastest during bouts of global influence, such as rising US rate expectations in Q4

Chart 8. China's housing affordability is deteriorating rapidly

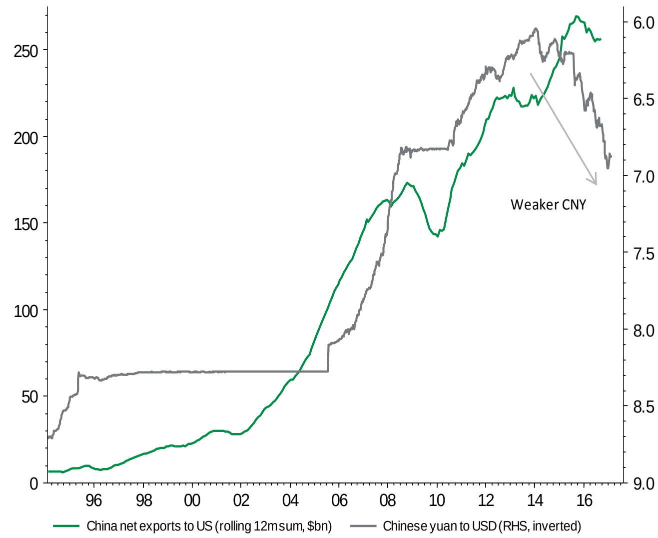
Estimated average house price-to-income ratios in major cities (latest data)



Source: CEIC, & Mizuho Securities estimates, based on NBS, & other national data

Chart 9. China's trade surplus with the US has been building

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



Source: Thomson Reuters Datastream

2015; Brexit fears in Q2 2016; and higher, Trump-inspired US inflation expectations in Q4 2016. **The likely persistence of these forces suggests some further downside for the RMB *(chart 9)*.**

Yet, for as long as 'free' trade continues, this should be gradual. The PBoC's preference is to avoid undue downward pressure on the renminbi, while also *"..ensuring aggregate demand management"*. Given currency depreciation effectively 'taxes' consumers (via inflation) over exports, 'gradual' fits with the long-term aim of rebalancing. After all, a lesson after August 2015 to October 2016's especially sharp $437bn reserve outflow (12% of total) is that depreciation is preferable to prolonged support of increasingly overvalued levels. Especially as the latter also questions China's commitment to US Treasuries.

But, the more serious risk is US trade tariffs. Retaliation by China would likely be sought by *inter alia* a large, 'bazooka' devaluation that clawed back some of the competitiveness-hit. But, this in turn risks imploding China's corporate and banks' balance sheets most exposed to USD debt. Hopefully, some of the outflows thusfar have reflected a net de-levering of this debt, in addition to lower renminbi deposits offshore, and, as the capital account opens, foreign asset purchases.

This latter force has probably come more from corporates than retail, given the bulk of average household wealth remains in relatively illiquid property. But, if needed, the PBoC may yet have to delve into its $3trn reserves (26% of China's GDP, or 12% of world central bank assets) to cushion the indirect blow of a 'trade war' on China's balance sheets.

In which case, an uneasy mix of currency depreciation, lower forex reserves, and selective defaults may be seen as the least disruptive option facing President Xi in the autumn, especially if he can whip up nationalist sentiment by 'blaming' them on the US. Slower world trade would also make it easier for him to explain away any shortfall from China's *"close to 6½%"* growth target. **Hopefully, given China's sizeable US Treasury holdings (at about 15% of total, the largest foreign holder), these provide a mutual deterrent. But if not, the mild 6-7% RMB/USD devaluation currently implied by forward contracts two-years out may be significantly underestimating the risk.**

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