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Economic outlook

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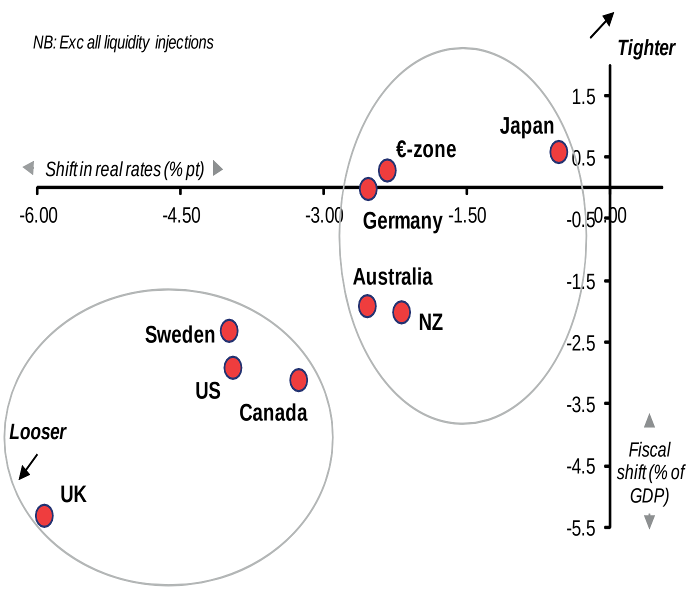
Looking into 2017...

Main points

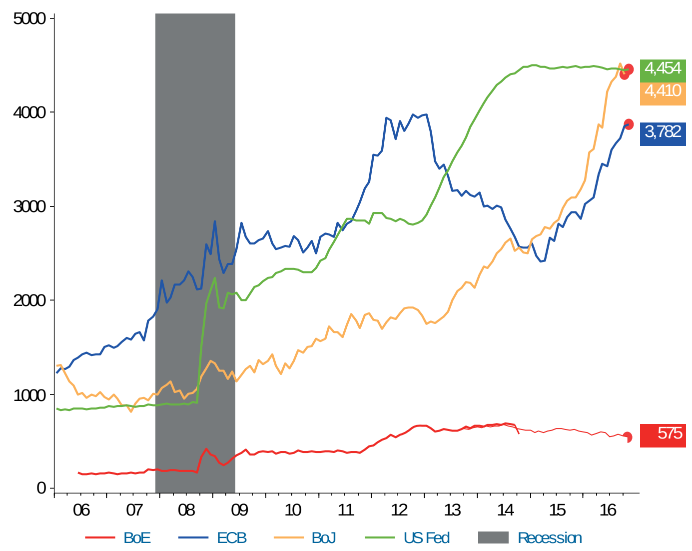
- After a year of political surprises, we could see tectonic shifts in economic policy. Speculation, rightly, that major economies will open the fiscal box is causing 'reflation trades' to puff up growth assets & make the bull-run in government bonds look even staler.
- Yet, while better for growth, markets may be ignoring the new global risk emerging. Rather than financial distrust, we may need to brace for political distrust, with the threat of beggar-thy-neighbour policies - from the US to Europe - rising.
- Amid these conflicting growth forces, our macro outlook is based on six core beliefs. First, governments in 2017 will offer fiscal solutions to add stimulus, try to appease electorates, & take the policy 'baton' back from central banks.
- Second, this comes *on top of* monetary expansion. Nine years after the first traces of crisis, yet central banks 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 liquidity taps without unintended consequences.
- Third, once protectionist forces build, inflation will reappear. But, it will be the 'wrong sort' – cost, rather than demand-led. Central banks will 'turn a blind' eye as economies stagflate, meaning the inflationary flame may snuff itself out without policy action.
- Fourth, China has the tools to soften its landing. But, fifth, for those non commodity-exporting emerging markets with high exposure to short-term USD debt/foreign saving needs, the outlook's less rosy.
- Finally, without convincing recoveries, any contagion (unlike 2008) may be political rather than financial. EU exit-fears will spread with our exit taking longer than the three years needed by Greenland.
- In which case, while reflation trades look appropriate in the short term, political disruption, protectionism, cost inflation, & dissipating growth suggest 'lower for longer' will have to persist.
- So, chasing the 'great rotation' means taking on the central banks. Because, for more fiscally-active governments, initiating also the end of QE would be like a turkey voting for Christmas...

Chart 1. Major economies can reflate by opening the fiscal box...
Shifts since 2000 in real rates (using CPI, 3m Libor), & cyc adj budget balances



Source: Hermes Investment Mgmt, based on OECD projections, IMF, & Bloomberg

Chart 2. As central banks keep the taps on to prop up growth assets...
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

Comment

After a year of political surprises, we could increasingly see tectonic shifts in economic policy. Speculation, rightly, that major economies will open the fiscal box is causing 'reflation trades' to lift US equity indices to new highs, raise inflation expectations, reduce the priority for rate cuts, and make the 30-year bull-run in government bonds look staler. Yet, while better for growth, markets may be ignoring the new global risk emerging. Rather than financial distrust, we may need to brace for political distrust, with the threat of beggar-thy-neighbour policies - from the US to an upsurge of anti-European populism - rising. In which case, without care, an unhelpful jigsaw piece that prolonged the 1930s depression but absent from 2008 - retaliatory trade protectionism - might come crashing into place.

Reflation, inflation, & political contagion, but too soon for the 'great rotation'...

Amid these conflicting growth forces, our macro outlook is based on six core beliefs. First, governments in 2017 will offer fiscal solutions to add stimulus, try to appease electorates, and take the policy 'baton' back from central banks. Mr Trump is set to reflate the US, and austerity in the UK is being deferred again *(page 6)*. It makes sense too for slower-growth Japan *(page 4)* and the euro-zone to loosen fiscally using the aggressive QE they're doing anyway to cap any rise in bond yields. The euro-zone's highly-charged political year adds urgency for this. This could help align them with the faster-growing US and UK whose net fiscal positions have loosened most ***(chart 1)***.

But, second, 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 1% in the US).

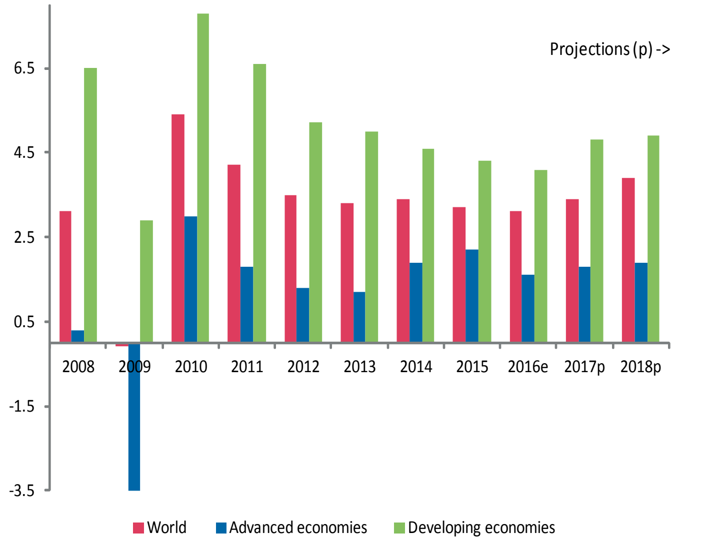
The question after eight years of QE amounting to $13trn is how central banks can turn off the liquidity taps without unintended consequences ***(chart 2)***. We expect them to continue, with 'their skin in the game' via bloated balance sheets suggesting they cannot take us off guard.

Third, should protectionist forces build, which seems likely, inflation will reappear. But, it will be the 'wrong sort' – cost-push, led by tariffs, goods and labour 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.**

For this reason, 2017 could be a 'year of two halves'. The initial stimulus from President-Elect, Trump's proposed fiscal expansion could become muted by his threat of widespread protectionism, and possible distress to US asset prices. Congress might 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 *(page 3)*.**

In which case, expect a broadening out to other countries (especially emerging markets) whose 'cheaper' imports then fill the gap. **Global retaliation could follow, and a flow-back from Mexico (which relies on the US for 80% of its exports and the bulk of remittances), Canada, and a China currency devaluation more aggressive than the mild 5-6% fall assumed by forward contracts for two years time.**

Chart 3. World growth - the onus may tilt back to the advanced economies
Real GDP growth outlook (%yoy) for world (IMF proj'ns), & advanced/developing economies



Source: Bloomberg, based on national data, & IMF (World), & consensus (other) projections

With competitive devaluations then elsewhere (e.g. S.E. Asia), the deflationary return to the US could be much larger than anticipated.

Fourth, China is slowing, but has other tools to soften the landing. The main macro dilemma is supporting growth, yet minimising a boost to the housing market. There, affordability in the main cities (10 times incomes in Beijing and Shanghai, 30 times in Shenzhen) has deteriorated faster than in other world financial centres *(page 7)*.

For other emerging markets, the outlook in a more protectionist, strong USD, rising-yields, scenario is less rosy than the IMF expects *(chart 3)*. 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. But, for others, external debt-ratios are lower, with fewer currency pegs to have to protect. And, where domestic debt climbs, they can run QE.

And, finally, without convincing recoveries, any contagion, unlike 2008-09, may be political rather than financial. Passage of Italy's Constitutional referendum result sets up the euro-zone up for a highly charged political year ***(page 5)***. **EU exit-fears could spread beyond the UK.** Yet, with the EU's status questioned, on-going QE, and possible USD repatriation under Mr Trump, this could helpfully soften the euro.

But, other than *tapering* QE, the ECB may not raise its negative deposit rate before Brexit risks look clearer. And, with elections coming in France, Germany, The Netherlands, and maybe now Italy and Spain, there may be little sympathy for a quick, 'no-strings' UK deal once Article 50 is triggered. **Our exit negotiations could thus take much longer than the three years needed in 1982-1985 by Greenland.**

In which case, while the reflation trade looks appropriate in the short term, the spectre of political disruption, increasing protectionism, cost inflation, and dissipating growth mean 'lower for longer' and the grab for yield will persist. And, with the liquidity taps still on, chasing the 'great rotation' of an *en masse* shift out of bonds means taking on the central banks. Because for more fiscally-active governments, initiating the end of QE would be like a turkey voting for Christmas.

United States

Markets may become increasingly more defensive once Mr Trump's new administration gets its 'feet under the table' in January, given potential for a paradigm-shift that eventually disrupts economic policy and US assets. With some of his fiscal and immigration proposals looking extreme, he will doubtless 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' 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.

President Trump could invoke 'Super 301' to unilaterally impose trade tariffs...

The initial stimulus from Trump's proposed fiscal expansion could become muted by his threat of widespread protectionism, and possible USD strength on repatriation. Disruption would be exacerbated if he repeats his threat to reschedule US government debt/and or interfere in the Fed's decisions. The former, though, seems unlikely and unnecessary, given the debt is denominated in USD.

This is a just as well, given the President's first visible macro test will be to raise the $18.1tn debt ceiling in March. This sets the theoretical cap on government financing, currently a record $18.1trn. **Extending this to 15 March 2017 eased obfuscation in election year, but now leaves it as first test of his new administration - especially as fresh commitments have since unofficially breached it, to $19trn *(chart 4)*.**

Unless dealt with effectively, the threat of government shutdown, unpaid obligations, and default risk would offer an additional route to the recession predicted ahead of the 2018 mid-terms by the Treasury curve. **'Default' is really likely only via inflation, yet, if akin to previous shutdowns such as August 2011, equities and ratings could suffer.**

So, after an initial boost, growth could slow again, and give a weaker footing for an economy that may have to weather some subsequent distress to asset prices. He advocates across-the-board tax cuts skewed toward higher earners, increased infrastructure spending, yet reductions to immigration and trade. **Taken literally, this infers a hit to tax revenue of about $4tn (22% of GDP) over five years, only part financed by spending cuts.** Congress would likely push back on this.

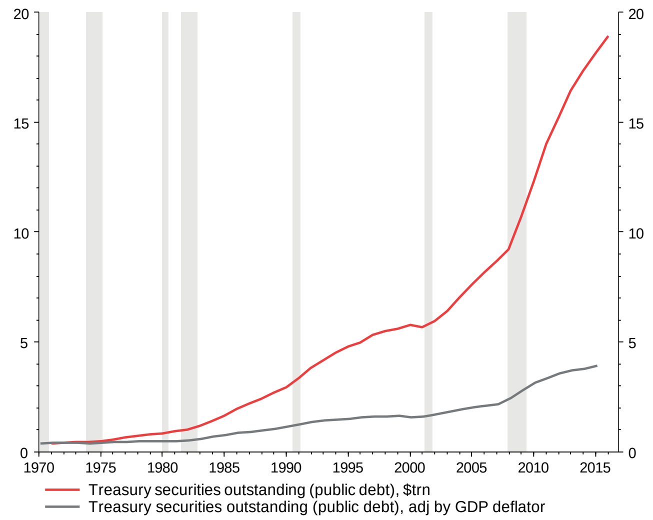
Economic & interest rate estimates (e) & projections (p)

% yoy unless stated	'11	'12	'13	'14	'15	'16e	'17p
Real GDP	1.6	2.2	1.7	2.4	2.6	1.6	2.4
Personal consumption	2.3	1.5	1.5	2.9	3.2	2.6	3.0
Business investment	7.7	9.0	3.5	6.0	2.1	-0.4	2.6
Industrial production	3.0	2.8	1.9	2.9	0.3	-0.7	1.3
Consumer prices (nsa)	3.2	2.1	1.5	1.6	0.1	1.3	2.3
Unemployment rate (%)	8.9	8.1	7.4	6.2	5.3	4.9	4.6
Current account (% GDP)	-3.0	-2.8	-2.2	-2.3	-2.6	-2.6	-2.8
Fed budget balance (% GDP)	-7.9	-6.5	-3.3	-2.8	-2.6	-3.0	-3.5
Funds target (yr-end, %)	0.25	0.25	0.25	0.25	0.50	0.75	1.00

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

Chart 4. US Federal debt - in nominal & real terms

Both $trn. Real is nominal adj by GDP deflator (1970 Q1 = 100). Grey denotes recession



Source: Thomson Reuters, based on US Dept of the Treasury, & BEA data

It could 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 then fill the gap. **Global retaliation could follow, and a flow-back from Mexico (which relies on the US for 80% of its exports and the bulk of remittances), Canada, and a likely China currency devaluation.**

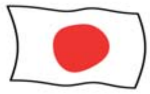
Mr Trump's threats also to ring-fence Mexico, and increase the deportation of illegal immigrants (11.3 million over two terms) would, unless offset, accelerate the shrinking labour supply. This is akin to 7% of the workforce, or 3-4 times the maximum achieved *per annum* under Obama. **This threatens the element in short supply during the official seven-year business expansion: stronger potential growth.**

The OECD expects potential growth to be just 1½% in 2017 - no better than the current recorded growth rate. 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 (+9% since the crisis) has helped average wages (+19%) beat the CPI (+14%). By comparison, the UK's flat productivity has impeded wage growth (17%), relative to the RPI (+26%).

Part of this puzzle is linked to disparate trends in worker participation rates. The US's unemployment fall has been widespread, but, the labour pool is shrinking. 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 4.6%, lies easily under the FOMC's 5¼-5½% NAIRU range. This is in contrast to the steadily rising labour force in the UK, euro-zone and Australia.

Such a cut to the labour pool could further spur wages. Yet, the hit to consumers and firms from the cost-push inflation that protectionism spawns suggests any demand-lift from a more isolationist US will be short-lived. In which case, the FOMC may be loathe to hike again - especially with presidents George, Mester and Rosengren, who opted to hike in September, next year losing their rotating voting-status.

Japan



PM Abe and the BoJ have every incentive to accelerate growth and an inflation rate that's fizzled out, exacerbated by the yen's 'safe haven' status. September's ¥13½trn ($125bn) 'real water' spending expansion on earthquake reconstruction, infrastructure, SMEs, and the lower-income end had limited impact, suggesting the fiscal lever will be pulled again. 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*, it's already mopping up JGBs at more than twice the pace of net supply (¥ 38trn) - doubling under governor Kuroda its share of JGBs outstanding to 45%. This ironically leaves private institutions increasingly short of bonds to buy

Falling land prices was the common link causing policy-makers to back-track...

Yet, after 18 years of monetary expansion, other options look limited. The BoJ has since the spring 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 piece-meal, and leaves the larger, existing portion 'attracting' 0.1%. Governor Kuroda's scepticism just before the move, the BoJ's slender 5-4 vote, and the confluence of weak Q4 2015 data smell of political pressure.

As does the BoJ extending to FY2018 (year starting March 2018) its pledge to hit the +2%yoy CPI target. Postponement helped Abe win last July's election, and this latest delay (the fourth) now takes pressure off BoJ governor Kuroda before his term expires in April 2018. Rates will be cut further, though, especially if the yen receives unwelcome support from Brexit and the ending of the Fed's rate tightening policy.

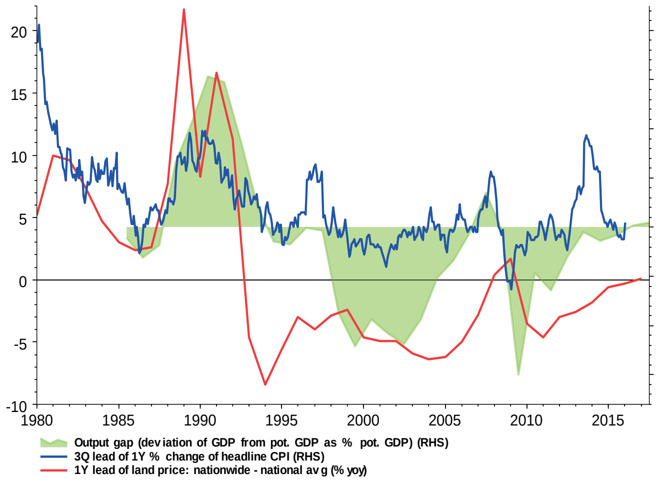
Encouragingly for debt ratios, nominal GDP is 7% higher under Abe, driven by mild price gains (using the GDP deflator). But, real GDP is flatter, and likely to no more than zig-zag. It was slow to rebound from a sharp drop in Q2 2014, initiated by the first leg of the sales-tax rise, from 5% to 8%. With demand front-loaded, the authorities expected a recovery in Q3. But, by GDP falling then stuttering, Abe wants to avoid a sixth GDP-based recession since 2008. And, with consumption on the government's synthetic, monthly reading (which precede GDP data) turning down again, more stimulus is needed.

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

% yoy unless stated	'11	'12	'13	'14	'15	'16e	'17p
Real GDP	-0.4	1.8	1.4	0.0	0.6	0.8	0.7
Private consumption	0.3	2.3	1.7	-0.9	-1.2	0.4	0.6
Business investment	4.1	3.6	-0.3	2.8	1.6	0.6	1.2
Industrial production	-2.6	0.2	-0.6	2.1	-1.2	-1.0	0.6
Consumer prices	-0.3	0.0	0.3	2.7	0.8	-0.2	0.4
Unemployment rate (%)	4.6	4.3	4.0	3.6	3.4	3.2	3.1
Current account (% GDP)	2.2	1.0	0.9	0.8	3.3	3.6	3.4
Gen budget balance (% GDP)	-8.8	-8.7	-8.5	-7.7	-6.7	-6.3	-6.9
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

Chart 5. Inflation fizzles out, but land prices have stopped falling
Nation-wide land prices & CPI (both %yoy), vs output gap estimate



Source: Ministry of Land Infrastructure & Transport, MIAC, & OECD

Little wonder the second leg of the tax rise, to 10%, is deferred to October 2019. An important consideration is land prices, which only in 2015 started to stabilise ***(chart 5)***. **Falling land prices was the common link when both 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.** Delaying the tax rise this time offers them more time to recover.

While helpful, this together with the previous two sales-tax deferrals and corporate-tax cut, from 32% to 29%, of course postpones fiscal consolidation. Specifically, the tax-hike postponement foregoes a proportionate lift to the CPI, and its contribution to the ¥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 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 (BoJ staff Paper, February 2014).

Yet, the annual wage-round (*shunto*) was tame again last spring, with the +2.1%yoy average, one-off wage hike no higher than 2015's round. These are unlikely to be sustained, and political pressure on firms to raise wages is building. Inflation has collapsed as the tax's base-effect washed out and the yen picked up. But, consumers have yet to be compensated for the 4% *cumulative* price rise under Abe.

So, PM Abe's pro-growth policies will carry over, almost unhindered by political risk. He boosted his LDP/Komeito coalition's hold on the Upper House in July. This adds to his extension in 2015 of the LDP presidency, and two-thirds Lower House majority. Importantly, by holding a two-thirds 'super' majority in each, he now has two of the three requirements needed to trigger Japan's most widespread constitutional change since 1947, the other being a referendum. **The way thus looks clearer for nuclear power and defence reform. And - by effectively securing his position to 2018 - Abe can now test Koizumi's record in 2001-06 of staying in office for five and half years.**

Euro-zone

Passage of Italy's Constitutional referendum result on 4 December sets up the euro-zone up for a highly charged political year - offering policy disruption, and, partly as a sweetener to electorates, some fiscal expansion. Italy's vote, by about 60% to 40% against PM Renzi's reforms to dilute the Upper Chamber looks at best double-edged. While it helpfully avoids raising the power of government when anti-establishment sentiment is building, it also risks messy elections, banking collapse, and the threat of an anti-euro referendum. Italy's banks need repair (NPLs average almost 20% of total), Greece has lost a fifth of its real GDP since austerity, and Italy/Spain are still running 36%/43% male-youth unemployment rates to stay on Germany's macro 'coat tails'. This suggests reform fatigue and populist parties will continue to build.

Already halfway down the Japan route, the euro-zone can open the fiscal box...

Dealing with this would push euro-zone policy further down the Japan route. By running QE and negative rates, but, as yet, reluctant to loosen the fiscal reins, the euro-zone already looks halfway. We expect it to fulfil this third requirement by selectively pushing on the fiscal lever, to supplement QE, support growth, and go some way to appeasing disenchanted voters. While political incentives are building, the economic justification now looks easier. **As an amorphous bloc, austerity has pulled down the zone's budget deficit from 6¼% of GDP in 2009 to just 2%, visibly below the 3% Maastricht 'test' for EMU.**

This makes it easier presentationally for fiscally-prudent Germany to 'turn a blind eye' to profligacy, despite their protestations, by the higher-debt members needing to maximise growth. 'Helicopter money' is considered a next step. **This would go some way to aligning the euro-zone with the faster-growing US and UK, whose net fiscal positions have loosened the most since the euro** ***(chart 1)***. Together with on-going monetary stimuli - even as QE becomes tapered - this raises the chance of keeping the euro down. A hitch is the absence of a region-wide fiscal agency, which precludes a unified giveaway akin to the US's tax-rebate cheques 'dropped' to consumers in 2001 and 2008.

But, this could still be done nationally, perhaps in a coordinated way, supported (by actions if not words) by the ECB's bond buying. Given the ECB's concern since the spring about *"political risk"* (reform-reluctant populist parties) potentially contributing *"to contagion and refragmentation"* of the zone, it should at this lower deficit ratio, be seen as the lesser of 'two evils'. Reform pledges could become back-end loaded to allow growth to breathe and avoid credit downgrades.

One complication is when EU exit-fears spread beyond the UK. With the EU's status questioned, on-going QE, and possible USD repatriation under Mr Trump could helpfully soften the euro, which stands about 6% higher since ECB QE started in March 2015. **This additional easing may then make it easier for the ECB to taper its bond purchases from the current €80bn per month.** But, it may not be ready to raise its negative, -0.4% deposit rate before Brexit risks look clearer. With elections coming in France, Germany, The Netherlands ***(chart 6)***, and maybe now Italy and Spain whose coalition looks weak, there may be little sympathy for a quick, 'no-strings' UK deal.

In the meantime, the ECB will take out as much as it dare from an emptying 'tool-box', continuing its long-term refinancing operations that effectively reward banks that lend. The transmission mechanism through to the real economy has been painfully slow. But, a lesson from Japan is that QE provides cash to lend, but cannot force consumers and firms to borrow. And, as the ECB's Bank Lending Survey reveals, only in the past year has increasing credit availability been matched by rising corporate and housing-loan demand.

Tackling the cause of the problem - a monetary union bereft of economic union - always needed more than just QE. Its effectiveness hinges on capping long rates, given the ECB's commitment to buy bonds to a yield as low as the negative deposit rate. This should increasingly stimulate consumption, with roughly two-thirds of euro-zone private borrowing (personal and corporate) is long-rate, rather than short rate, driven. This is the mirror image of the UK.

Yet, euro-zone velocity (nominal GDP/broad money supply) has only flatlined since 2008, while the UK's has been rising, aided by housing's sensitivity to short rates. **Either way, despite an improving periphery, it will take years before the converging countries can reclaim their GDP lost - with Italy and Greece's real GDP, on a net basis, still yet to rise with the euro. So, it looks time to open the fiscal box.**

Chart 6. The euro-zone's highly charged political year

Key scheduled & expected political events in 2017

22 Jan	France - 1st round of Socialist primaries
29 Jan	France - 2nd round of Socialist primaries
12 Feb	Germany - Presidential election
15 Mar	**Netherlands - General election**
26-Mar	Germany - regional election in Saarland
(Mar/Apr	**UK triggers Article 50?)**
(Apr/May	UK council elections)
23 Apr	**France - 1st round of Presidential election**
7 May	**France - 2nd round of Presidential election**
7 May	Germany - regional election in Schleswig-Holstein
14 May	Germany - state election in North-Rhine Westphalia
June	France - Election of Lower House
Sept/Oct	**Germany - Federal election**

Source: Hermes Investment Management

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

% yoy unless stated	'11	'12	'13	'14	'15	'16e	'17p
Real GDP	1.6	-0.9	-0.3	1.2	2.0	1.6	1.6
Private consumption	0.0	-1.2	-0.5	0.8	1.8	1.7	1.7
Fixed investment	1.8	-3.3	-2.5	1.4	2.9	2.5	2.0
Industrial production	3.6	-2.3	-0.7	0.9	2.0	1.6	1.5
Consumer prices (HICP)	2.7	2.5	1.3	0.4	0.0	0.2	1.3
Unemployment rate (%)	10.2	11.4	12.0	11.6	10.9	10.1	9.8
Current account (% GDP)	0.2	1.3	2.2	2.4	3.1	3.2	3.0
Gen budget balance (% GDP)	-4.2	-3.6	-3.0	-2.6	-2.1	-2.0	-2.4
ECB refi' rate (yr-end, %)	1.00	0.75	0.25	0.05	0.05	0.00	0.00

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

United Kingdom

With the BoE relaxing monetary policy again after the Brexit vote, sterling falling, and the Chancellor delaying fiscal austerity even further, we update our 'Policy Looseness Analysis' to gauge how the UK's overall macro stance will shift in 2017, and compare it with that of previous years. Past attempts to quantity the appropriateness of policy, such as the 'Taylor-Rule' used by the US Fed, lack explicit consideration of QE and the accompanying fiscal stance. But, to assess the full impact and get a truer picture of the *de facto* BoE policy rate, we go beyond convention by adjusting the BoE's real Bank rate for QE (the real, QE-adjusted rate), and mapping it against the latest underlying fiscal outlook just set out by the OBR.

Brexit savings will not be enough to counter the £122bn extra borrowing...

***Chart 7* summarises the result.** We quantify the impact of QE by adjusting real rates for the BoE's 2009 staff estimate that £200bn in QE was akin to 150bp off the Bank rate. At that stage, Bank rate was just 0.5%. Extending this logic to the cumulative £445bn QE since 2009 (including the extra £70bn announced in August to cushion the Brexit vote), thus infers about 330bp total easing, and a *current* UK policy rate of about -2½%. This is notably lower than the 0.25% official Bank rate.

As for 2017, even the absence of a further rate cut contributes to a lower nominal rate of -3% when we input QE. **This equates to a -4% real rate when we factor in expected CPI inflation.** We expect the CPI to drift up on pass-through of sterling's weakness and base-effect from oil, to average +1.7%yoy in 2017 after 0.6% in 2016. *Chart 7* plots these *real*, QE-adjusted rates. **With the QE stock sustained by reinvestment, running true rates this low should keep the MPC wary of loosening again if Brexit's impact is contained. And, especially if faster, sterling-induced inflation since the summer begins to spur wage growth.**

Helpfully, pressure on the MPC will be lifted by the lightening of former chancellor, Osborne's austerity plans. Incorporating the OBR's latest fiscal deficit projections in (new) chancellor Hammond's Autumn Statement, ***charts 7*** maps how the overall policy stance has evolved. It shows: *(i)* how tight the overall stance was around the 2000 dot.com boom; *(ii)* how much looser it had to become after 2008's crisis; and *(iii)* that, **despite the Chancellor's latest loosening relative to plans, any policy normalisation is coming from the fiscal, not monetary, side.**

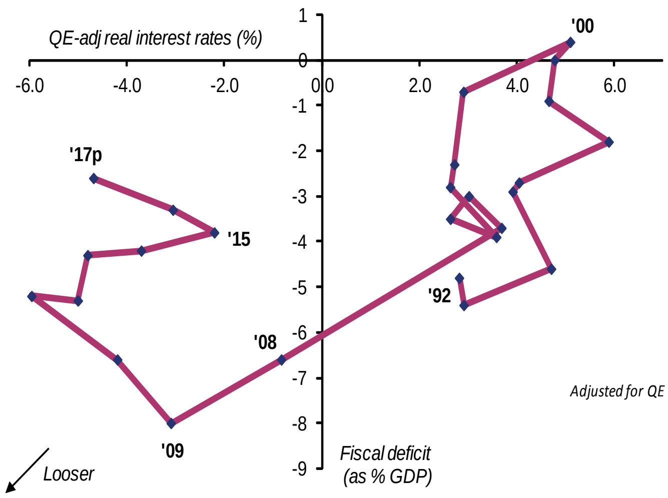
Economic & interest rate (e) & projections (p)

% yoy unless stated	'11	'12	'13	'14	'15	'16e	'17p
Real GDP	1.5	1.3	1.9	3.1	2.2	1.9	1.0
Household consumption	-0.7	1.9	1.6	2.1	2.6	2.5	1.3
Fixed investment	1.9	2.3	3.2	6.7	3.4	0.5	-2.0
Manufacturing production	1.8	-1.5	-1.0	2.9	-0.1	0.3	0.9
Retail prices index	5.2	3.2	3.1	2.4	1.0	1.7	2.0
Consumer prices	4.5	2.8	2.6	1.5	0.0	0.7	1.8
Unemp, ILO rate (3m av, %)	8.1	8.0	7.6	6.3	5.4	5.0	5.3
Current account (% GDP)	-1.8	-3.7	-4.4	-4.7	-5.3	-5.6	-4.3
Gen budget balance (% GDP)	-7.1	-7.3	-5.9	-5.0	-4.0	-3.5	-2.9
BoE Bank rate (yr-end, %)	0.50	0.50	0.50	0.50	0.50	0.25	0.25

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

Chart 7. This is how the UK's policy stance is shifting, adjusted for QE

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



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

The Treasury is no longer aiming to return the finances from 'red to black' by 2019/20. Yet, with borrowing lifted again and Brexit looming, Hammond is not letting his guard down completely. The squeeze is just deferred. An underlying balance is still targeted, but now not till about 2022/23. **And, with lower-than-planned tax revenue since the Budget and softer GDP assumptions, Brexit savings (£8-10bn *p.a.*) are clearly not enough to counter the £122bn extra borrowing over five years.**

This slippage amounts to 5% points of GDP compared with March's Budget. And, while limited by funds from bank proceeds and the BoE's deferral of asset sales, the peak in the debt stock, at 90% of GDP, is pushed back another two years. There is help for the lower-income end and savers, and honouring commitments on infrastructure and corporation tax to help firms in the Brexit firing line. But, while helpful to longer-term growth and competitiveness, these measures may short-term have more micro than macro effects on the economy.

Meanwhile, the extent of Brexit damage still probably rests on the manner of the exit. The mark-down on assets would surely be greatest in the case of a 'hard exit' - entailing an acrimonious departure, lower trade, lower migration and recession - than the more probable 'softer' version which markets are presumably pricing in. **But, even a 'soft exit' to a Norway or Switzerland-style associate membership will probably need several years just to end up close to square one.**

The challenge now is to remain at, or close enough to, the European negotiating table to secure the best possible trade and regulatory deals for the services sector as a whole. Services represent as much as 80% of the UK's gross value added, compared with 50% in Germany and 60% in France. They have been the heartbeat of the UK's recovery. Yet, most existing EU trade deals exclude services, and those that do, require free movement of people and shared regulations.

Which leaves the BoE watchful a weaker pound doesn't pump inflation. Our simulations at current GBP/USD and oil price have the CPI breaching (just) its +2%yoy target by May 2017. Further GBP weakness and/or oil strength pushes it toward 3%. But, should that occur, we doubt the Bank would react, given the feared hit to growth. Even with austerity delayed, and negative QE-adjusted rates.

China

Renminbi depreciation is likely to remain the authorities' preferred pressure release as they grapple with slower growth, capital outflows, external headwinds, and, technically, the new trade-weighted currency basket where adjustments are made to compensate for USD swings. On macro policy, the main dilemma will be supporting growth, yet minimising any additional boost to an overheating housing market. There, affordability in the main cities (10 times incomes in Beijing and Shanghai, 30 times in Shenzhen) has deteriorated faster than in other world financial centres *(chart 8)*.

PBoC would have to act if retaliation to US tariffs hurts China's balance sheets...

Much of this excess is the overhang of 2008's massive 8%-of-GDP fiscal splurge, and credit expansion. The leaves the authorities wary of overcapacity, yet mindful that restricting credit now risks a more pervasive slowdown ***(chart 9)***. RMB depreciation looks the most feasible option for stimulus. 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 2015; Brexit fears in Q2 2016; and higher, Trump-inspired US inflation expectations in Q4 2016. **The likely persistence of these forces suggests further downside for the RMB.**

For as long as the US Fed pursues only a slow, shallow tightening path, this will be intended to be only gradual. The PBoC's Q4 2015 *Monetary Report* hinted at avoiding 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. A lesson after August 2015 to October 2016's $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 is then likely to be sought by *inter alia* a large, 'bazooka' devaluation that claws back some competitiveness. But it also risks imploding China's corporate and banks' balance sheets most exposed to USD debt. Capital outflows since 2014 have hopefully reflected a net de-levering of this debt. This is 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 less affected by the official $50,000 *per annum* capital control. **But, if needed, the PBoC may have to delve into its $3.1trn 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.**

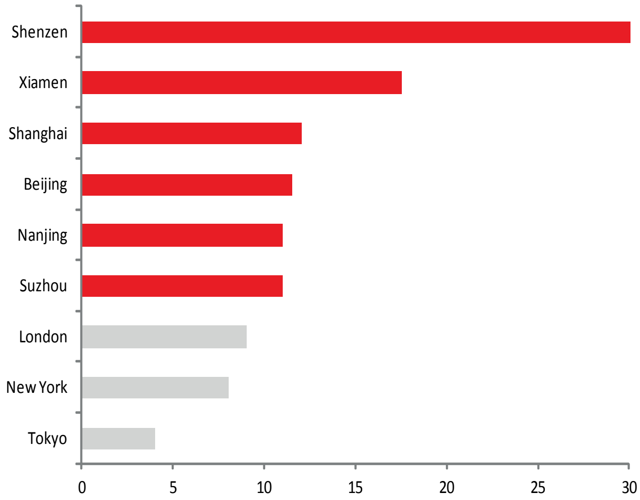
Hopefully, given China's sizeable US Treasury holdings (at about 15% of total, the largest foreign holder), these provide a mutual deterrent. **But if not, the mild 5-6% RMB/USD devaluation implied by non-deliverable forwards two-years out may be underestimating the risk.**

Either way, domestic challenges will include dealing with a property sector where transactions are still outpacing new starts by about two-to-one, and growing industrial slack. So far, systemic market risk looks contained. Overnight Shibor has lifted gently from 2% to 2¼% as global inflation expectations build, but still with none of the elevated spikes seen for example in 2011's hit on the shadow banking sector, and around August 2015's 3% currency devaluation.

Higher money rates also signal that, with housing in mind, the PBoC's two-year rate cutting cycle has ended. Real lending rates now under 3% for consumers and 4% for enterprises (using producer prices) represent a significant easing respectively from 5% and 11% in 2015. Yet, by holding reserve requirement ratios at 15-17%, the PBoC is discouraging bank largesse. And, after nearly five years of deflating, a levelling of producer prices should further help corporates.

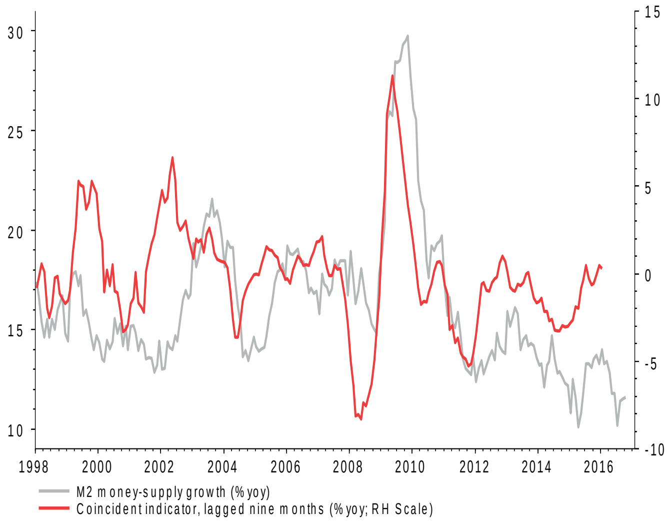
Store will also be put on fiscal expansion. With 2015's budget deficit officially reported at just 3½% of GDP, the traditional levers could be pulled to hit 2017's likely *"close to 6½%"* growth target. These include agricultural subsidies, state-led capex, infrastructure spending, as well as lending to preferred sectors such as agriculture and SMEs. And, should domestic debt strains build, China too could run QE.

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. Yet without stimulus, China could slow further
China's coincident indicator (lagged 9m), vs M2 money-supply growth (%yoy)



Source: National Bureau of Statistics, & People's Bank of China

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