OUTCOMES BEYOND PERFORMANCE

ECONOMIC OUTLOOK

Overly protective...

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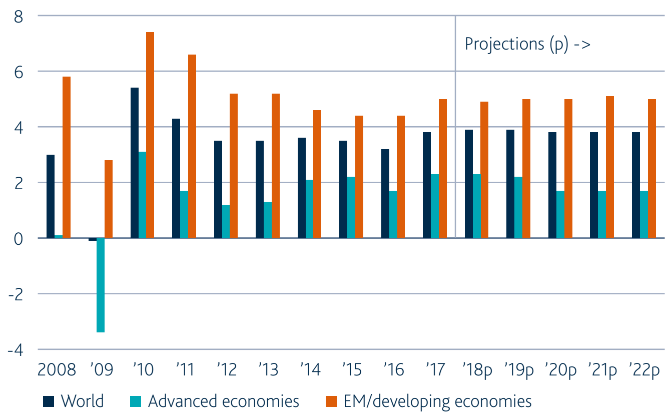
HERMES
INVESTMENT MANAGEMENT

MAIN POINTS

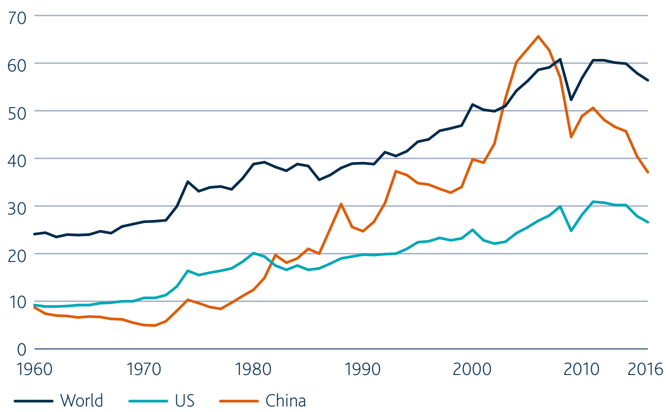
- Markets are still taking a 'glass half full' view of the macro outlook, with little real consideration of the new risks emerging. So far this has made sense, with speculation the US would open the fiscal box having justified 'reflation trades'.
- Yet, while better for growth, markets are ignoring the 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, on the rise.
- In which case, 2018 could be a 'year of two halves', where stimulus, euphoria gradually gives way to stagflation concern. Helpfully, the trade-off is that policy rates stay lower than many expect.
- The impact of protectionism this time would be more complicated than the 1930s. First, economic and financial linkages suggest the knock-on would be more far reaching. Global retaliation would activate second-round effects that later offset the growth-impulse from President 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, and the US's already shrinking labour supply and potential growth, reduced further.
- Third, should protectionism build, inflation will reappear. However, with the possible exception of the US, it will 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.
- In which case, 'loose for longer' probably has years left to run. Even in the US, true real rates (adjusted for QT) will stay negative, with 'peak' rates much lower than we are used to.
- So, the question after nine years of QE is how central banks turn off the taps without unintended consequences. Their 'skin in the game' suggests they cannot take us off guard. In the 1930s, US QE ran unbroken for 14 years. Protectionism, if it comes again, may mean we are little more than half way through this era of cheap money...

Chart 1. Major economies are expected to carry on growing...
IMF's real GDP-growth projections: world, advanced, & EM/developing economies (%yoy)



Source: IMF's January 2018 updated world economic projections.

Chart 2. ...On the assumption that world-trade growth is largely unabated
World, US, & China's trade (exports plus imports)* as a share of their respective GDP (all %)



Source: World Bank data (*goods & services).

COMMENT

Markets are still taking a 'glass half full' view of the macro outlook, with little real consideration of the new risk emerging. So far this has made sense. Speculation the US would open the fiscal box has justified 'reflation trades', taking US equity indices to new highs, keeping volatility low, lifting inflation expectations, and making the bull-run in government bonds look staler. Yet, while better for growth (chart 1), 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, 2018 could be a 'year of two halves', where stimulus-euphoria gives way to stagflation concern.

2018 could be a 'year of two halves'...

As chart 2 attests, the world's appetite for international trade has, as a share of GDP, more than doubled in the past 50 years. Yet, without care, an unhelpful jigsaw piece from the 1930s – retaliatory 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 hit the US's small number of trading partners (notably Canada and Europe), and prolonged the depression.

US Congress this time has pushed back on a general approach. Yet, Mr Trump could still fully invoke 'Super 301' (Section 301 of the 1974 Trade Act) to impose tariffs without its or WTO approval, on countries deemed (by him) to be engaging in "unfair" trade practices against the US. The risk then is a 'bar-room brawl', triggered by a policy face-off between the US, China, and an EU already taken up with Brexit and Italy's politics.

Threatened US tariffs on steel and aluminium imports and the administration's investigations into both alleged intellectual property-rights violations in China and auto imports (aimed at Europe and Mexico) look potent first steps. They could spark retaliation unless there are more conclusive trade talks now that China's National Congress has passed. While not widely used since the WTO's formation in 1995, US disaffection with the WTO and Trump's need to gain favour into November's Mid-Terms provide extra incentives to play this card.

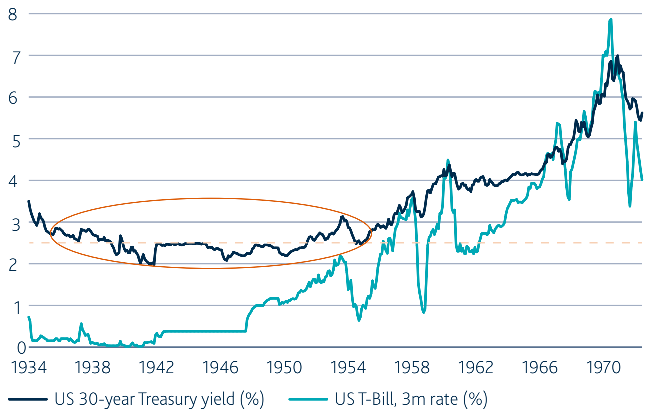
The impact this time would be more complicated than the 1930s. First, economic and financial linkages suggest the knock-on would be more far reaching. Central to our US growth projections (page 3) is that retaliation – may it be tit-for-tat tariff rises, qualitative barriers and/ or competitive currency 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 EU deal it signed in 2016. The UK (page 6) may have to wait as long (seven years) for something similar.

The broader mix of countries affected would include the emerging markets whose 'cheaper' imports then fill the gap. Especially heavy-hit may be Mexico (which relies on the US for 80% of its exports and the bulk of remittances), and Canada as NAFTA unwinds. China could react by devaluing its currency more aggressively than the 4% fall implied for three years time. This would spark competitive depreciations in S.E. Asia.

Second, despite the US being a relatively closed economy (chart 2), the deflationary return could be much larger than anticipated. A renminbi devaluation that hurt China's balance sheets (page 7) would question its commitment to US Treasuries just as the US budget deficit widens.

And, the threatened 35% and 45% tariffs on Mexico and China would surely disrupt US car manufacturers' own supply chains, and the ability/ cost of US companies' outsourcing their IT production. Setting up chains elsewhere may be more costly in a protectionist world.

Chart 3. QE in the 1930s was – like now – no 'flash in the pan'
Shows US 30-year Treasury Bond yield, & US T-bill 3-month rate (both %)



Source: Thomson Reuters Datastream, & Federal Reserve Board.

Also, should it come to it, 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 nine-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.

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/1990s recessions, than the overheating of the late 1980s/mid-2000s. The inflationary flame may thus snuff itself out without policy action.

In which case, with policy rates staying close to the floor, 'loose for longer' probably has years left to run. Even in the US, the test case for whether policy can be normalised, true real rates (adjusted for QT) will stay negative, with 'peak' rates much lower than we're used to (page 3).

For other emerging markets, the outlook in a more protectionist, strong USD scenario is less rosy. Clear vulnerabilities exist, such as those non commodity-exporting sovereigns with high exposure to short-term USD debt and foreign saving needs, including parts of Latam, Ukraine, S. Africa and Turkey. Thankfully, for most others, external debt-ratios are lower, with fewer currency pegs to have to protect. And if domestic debt-strains build, they too can run QE.

So, the question after nine years of QE exceeding $15trn is how central banks turn off the taps without unintended consequences. Their 'skin in the game' via bloated balance sheets suggests they cannot take us off guard. If the 1930s is any guide, US QE then ran unbroken from 1937 to 1951 (chart 3). Today, the Fed is not expecting its balance sheet to normalise till 2023 – even without protectionism. Yet, if it comes, we may be little more than half way through this era of cheap money.

UNITED STATES

To quantify the impact on rates and gauge how the overall (monetary and fiscal) policy mix should shift out to 2020, we update our 'Policy Looseness Analysis'. By taking explicit account of the past nine years of QE, actual and expected QT, and also 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 4% (closer to its 5% long-term average). At 225bp over the Fed's current range, any FOMC members targeting an unusually low peak rate are, helpfully, ignoring this Rule.

Fed will fall some way short of 'normal'

Charts 4 and 5 summarise the results. In each, we quantify the impact of QE on rates by adjusting real rates for former Fed chairman, Bernanke's assertion that the $600bn part of QE2 back in 2011 was equivalent to slicing an extra 75bp off the Fed funds target. See our *Tightening by doing nothing report* (May 2017) for more. This has led to a de facto (QE-adjusted) nominal Fed funds rate now of about -3%, much lower than the 'official' rate. This equates to a near -5% real rate when we adjust with the Fed's preferred core PCE projections.

On this basis, our analysis suggests the following. First, assuming symmetry for QT (that is, $600bn of QT would be equivalent to an around 75bp on the Fed funds rate etc), the Fed could by sustaining its programme 'take out' as much as 200bp of further rate hikes by 2020. Charts 4 and 5 are based on the Fed in 2019 and 2020 maintaining its $50bn per-month pace of QT after its end-2018 review.

To put into perspective, the possible cumulative $1.65trn of QT by 2020 would be significant (8% of US GDP). This represents over one third of the current balance sheet, approaching a half of 'excess reserves' (i.e. the around $3½trn accumulated since the global crisis). However, unless the pace of QT is accelerated further, it would on this basis need till 2023 before it is taken back to the $1trn considered 'normal'.

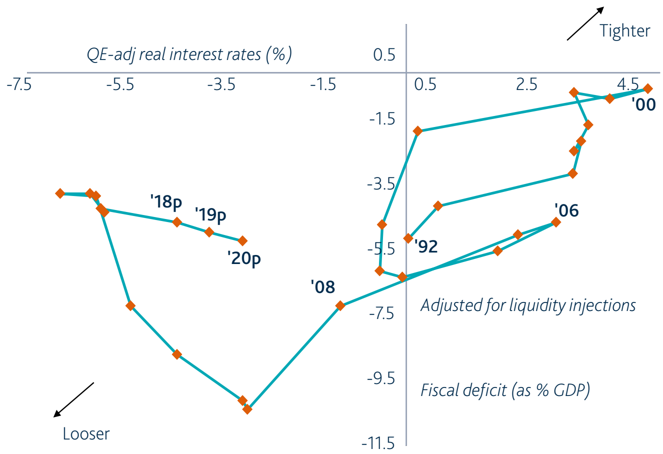
Second, given the assumed trade-offs, the process of interest rate normalisation will also be slow. Chart 4 is mapped on the basis described above, proxying both monetary and shifts, and uses our own Fed funds assumption of just two further hikes, partly facilitated by QT. In this instance, even the cumulative $1.65trn QT leaves the de facto, QT- adjusted, real funds rate in negative territory. Moreover, there's no offsetting shift in the underlying fiscal stance (using OECD projections).

Economic & interest rate projections (p)

% yoy unless stated	'13	'14	'15	'16	'17	'18p	'19p
Real GDP	1.7	2.6	2.9	1.5	2.3	2.8	1.8
Personal consumption	1.5	2.9	3.6	2.7	2.8	2.7	1.9
Business investment	3.5	6.9	2.3	-0.6	4.7	5.2	4.0
Industrial production	2.0	3.1	-1.0	-1.9	1.6	3.6	2.0
Consumer prices (nsa)	1.5	1.6	0.1	1.3	2.1	2.3	2.7
Unemployment rate (%)	7.4	6.2	5.3	4.9	4.3	3.9	4.0
Current account (% GDP)	-2.1	-2.1	-2.4	-2.4	-2.4	-2.5	-2.1
Fed budget balance (% GDP)	-3.3	-2.7	-2.6	-3.1	-3.4	-4.0	-4.8
Funds target (yr-end, %)	0.25	0.25	0.50	0.75	1.50	2.25	2.25

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

Chart 4. A very long road back to 'normal' – our dovish rate case...
US QE & QT-adj Fed funds rate, core PCE, & cyc adj fiscal balance. Hermes' rate view

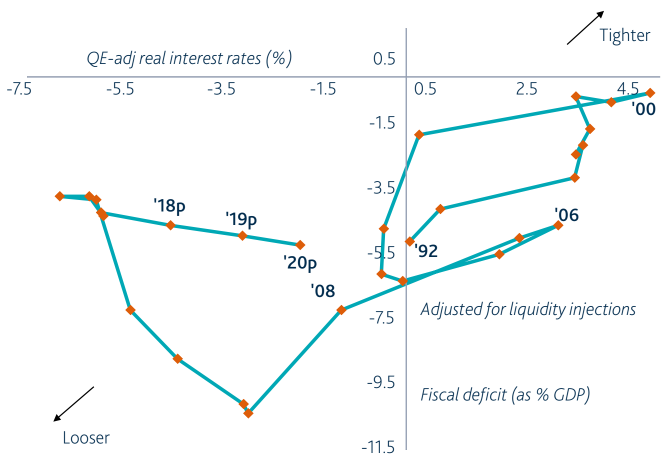


Source: Hermes Investment Management, based on OECD, FOMC, & Bloomberg data.

Alternatively, even the more hawkish rate assumptions of the FOMC, would (other things being equal) leave the QT-adjusted real rate abnormally low. Chart 5, drawn using the same QT and fiscal assumptions, but using the FOMC's 'dot-plot' rate path to a 3.25-3.50% peak, offers a still negative QT-adjusted real rate, even in 2020.

The FOMC will opine the cherished policy rate that they want to get closer to 'normal'. Yet, once QT builds, it may become clearer they needn't hike as far as the current dot-plot suggests – especially if inflation stays tame, the dollar lifts, and/or, linked to that, protectionism starts to hurt. All of which, of course, would support our long-held 'new normal' view of low-for-longer global rates and yields, rather than an imminent 'normalisation' to pre-crisis levels.

Chart 5. ...Even if the Fed does follow through on its rate threats
US QE & QT-adj Fed funds rate, core PCE, & cyc adj fiscal balance. FOMC's rate view



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

JAPAN

Political risk is returning, but should not be severe enough to loosen the LDP/Komeito's grip on power, nor cut short a policy-loosening now in its twentieth year. Prime Minister Abe's position was solidified last October by securing his LDP coalition's two-thirds 'super majority' in the Lower House. This, along with its existing super-majority in the Upper House and no repeat elections scheduled till 2021 and mid-2019 respectively, offers him chance to fill this tenure, and seek Constitutional reform, including defence. The question now is whether March's re-emergence of a favouritism scandal involving an allegedly discounted land-sale scuppers his authority into September's LDP leadership contest. While this may be the case, the weakness of the opposition DPJ should still keep his party in power.

Without inflation, this catch-22 precludes the BoJ from ever switching off its QE…

Either way, Japan's authorities still have every incentive to promote growth. Activity had been holding up. Real GDP till the end of CY17 rose for eight consecutive quarters – the longest stretch since the early 1990s asset-price collapse. Added to that, the output gap is positive, suggesting a return, if growth can be sustained above 'potential ', to economy-wide inflation (positive GDP-deflator). This reflects better external demand, a weaker yen, and rounds of monetary/fiscal stimuli.

Yet, the end of deflation is still not assured. GDP in Q1 2018 looks to have fallen back 0.2%qoq, led by capex, ending the growth-run. We still expect minimal, if any, true unwinding of QE in FY18 (year ending March 2019), and a continuation through Abe's tenure of his 'three-arrows' – of a looser monetary stance, expansionary fiscal stimulus, and structural reforms (labour market, corporate governance).

The latest form is the BoJ's targeting of a near-zero yield on 10-year JGBs, amid even lower short rates since April 2016. The idea is to both signal to banks that yield-curves will remain steep, and reassure the MoF that debt service costs will not be allowed to climb. The average JGB maturity outstanding is now up to nine years. While not a game-changer, it remains critical for an economy running the developed world's highest government liabilities-to-GDP, at about 230%.

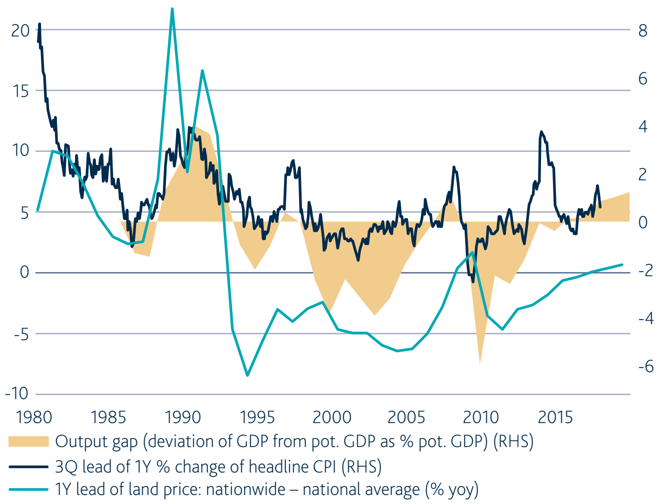
Yet, this catch-22 precludes the BoJ from switching off, or – without sustained inflation to erode the real value of the debt – cutting back on its QE. At ¥80trn per annum ($734bn) in total asset purchases – the vast bulk being JGBs, the rest ETFs and REITs – it's been mopping up

Economic and interest rate projections (p)

% yoy unless stated	'13	'14	'15	'16	'17	'18p	'19p
Real GDP	2.0	0.4	1.4	0.9	1.6	1.3	1.1
Private consumption	2.4	-0.9	0.0	0.1	1.0	1.0	1.5
Business investment	3.9	5.2	3.4	0.6	2.9	3.0	1.8
Industrial production	-0.6	2.1	-1.2	-0.2	4.4	2.6	1.9
Consumer prices	0.3	2.7	0.8	-0.1	0.5	0.7	1.6
Unemployment rate (%)	4.0	3.6	3.4	3.1	2.8	2.7	2.6
Current account (% GDP)	0.9	0.8	3.1	3.8	4.0	3.8	3.8
Gen budget balance (% GDP)	-8.5	-7.7	-6.7	-5.7	-3.5	-4.2	-4.0
BoJ target rate (yr-end, %)	0.10	0.10	0.10	-0.10	-0.10	-0.10	-0.10

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

Chart 6. Inflation flickers, but at least land prices have stopped falling
Nation-wide land prices, & CPI (both %yoy), vs output gap estimate



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

JGBs at twice the pace of net supply. However, depending on where global yields go, this ¥80trn may now vary depending on how much QE is needed to meet the around 0% yield target. Therefore, any fall should not be seen as a 'normalisation' or QT. For BoJ governor Kuroda, there is no QE "reversal" until a +2%yoy CPI (latest just 0.6%) becomes the norm.

Under Kuroda, the BoJ has doubled its share of JGBs outstanding to 48%. This leaves private institutions chasing riskier assets and/or looking overseas for bonds to buy, helping to hold down the yen. The MoF hopes that by maintaining a nominal growth rate above the average long-term interest rate, it can carry on borrowing without raising the debt ratio. Since they started yield-curve targeting, nominal growth has averaged 1.3%yoy. This leaves some officials believing the BoJ will be the last to stop QE, and even eulogising the MoF/BoJ's debt symbiosis.

Disappointingly, the deflationary psychology is still constraining wages. This spring's annual wage-round (shunto) was again tame, with large firms' 2% average one-off wage hike no higher than each of the 2014-17 rounds. These were not sustained, and it remains to be seen whether FY18's proposed tax credits for any firms that raise wages by 3% or more and/or increase capex beyond certain thresholds bear fruit. More likely, this effective tax cut will boost excess profits more than wages, and be offset by the higher-end tax rises planned for FY20.

Encouragingly, though, after falling for the best part of 25 years, land prices are now stabilising (chart 6). Building momentum here will be important for inflation, balance sheets and collateral. Falling land prices was the common link when the MoF raised the consumption tax in 1997 and 2014, and the BoJ ended its zero rate policy in 2000. Each time, they had to back-track as consumption slumped.

Therefore, Abe's preference to follow through on the third leg of the tax rise (our base case), from 8% to 10% in October 2019, is a gamble, and may have to be diluted fiscally. Abandoning it would forego a near proportionate lift to the CPI, and its contribution to a ¥12½trn (2% of GDP) fiscal-revenue lift from the two hikes together. Without plugging this gap, Abe's aim of a primary surplus by FY20 was always unlikely – even with the 2019 Rugby World Cup and 2020 Tokyo Olympics.

EUROZONE

To test whether the macro strains in the periphery are still holding back the core members, we update our 'Misery Indices' (MIs) to 2019. Off-the-wall methods for proxying economic hardship include an index adding together a country's unemployment and inflation rates. Though hardly scientific, they become especially flawed in a low inflation world when the components may move in opposite directions. We offer a logical alternative to this and to GDP estimates, which are produced with a lag and frequently revised. For our method, see our *Europe's highly-charged year* report (April 2017).

Converging on the strongest once again

Chart 7 summarises our predictions to 2019. Rising MIs predict greater economic hardship, relative to that country's past. On this basis, it offers the following observations. First, after a marked deterioration in €-zone members' MIs during the global crisis, improvement since 2014 looks to be sustained through to 2019. As a bloc, the euro-zone's (weighted) MI should, at -2, be its lowest since 2001.

Second, with growth now resuming, it is not surprising to see the sharpest improvement in most of those members that ran austerity to cut deficits and debt from 2010. Spain, Portugal, Greece, and Cyprus' MIs are now lower, albeit from a previously high base. However, for some others, unemployment and deflationary pressures from the fiscal squeeze are still dampening improvement in their relative positions. In 2018, Italy will lie in the above-average-misery zone for the ninth year running in chart 7. However, even these are much improved on 2010-14, and further gains look likely across the periphery.

Still, most revealing is what our MIs say about convergence (chart 8). The dip in the euro-zone's weighted average MI from the mid 1990s reflects Germany's recovery after its 1992-93 unification-led recession, and the benefits as the converging countries tried to reduce inflation, bond yields, debt and deficits. Our MIs reveal the two stages: from Maastricht in 1992 to the euro's birth; and thereafter, with the euro, a steady re-widening as policy discipline waned.

Convergence after Maastricht was solid. We proxy it by tracking the highest and lowest MIs each year. In 2018, Spain looks the 'happiest' relative to its recent past (GDP averaging +3.3%yoy since 2015), with Finland relatively the 'least happy' (+1.5%yoy). Greater convergence is shown by the narrowing gap between the two extremes. It suggests 2019 should see the joint largest degree of convergence since 2007, with the periphery leading the charge. This combination of reducing strains in the periphery with slower relative improvement in the core means divergence since the crisis is correcting. This is encouraging, though not sufficient for sustaining economic health. This still rests on the core, which account for 80% of euro-zone GDP, but their MIs are also better. So, while tackling the crisis needed more than low rates/QE, without them, Spain, Italy and others' competitiveness gains may have been offset by a stronger euro. Though not fixed, euro members do look on a stronger footing to weather the next challenge, linked perhaps to Italy's political risk.

Economic and interest rate projections (p)

% yoy unless stated	'13	'14	'15	'16	'17	'18p	'19p
Real GDP	-0.2	1.4	2.0	1.8	2.5	2.2	1.8
Private consumption	-0.6	0.9	1.8	2.0	1.8	1.8	1.6
Fixed investment	-2.4	1.9	3.1	4.5	3.2	3.3	3.0
Industrial production	-0.8	1.1	2.6	1.6	3.0	2.4	1.6
Consumer prices (HICP)	1.3	0.4	0.0	0.2	1.5	1.4	2.2
Unemployment rate (%)	12.0	11.6	10.9	10.0	9.1	8.5	8.3
Current account (% GDP)	2.2	2.4	3.2	3.3	3.5	3.2	3.1
Gen budget balance (% GDP)	-3.0	-2.5	-2.0	-1.5	-0.9	-1.1	-1.5
ECB refi' rate (yr-end, %)	0.25	0.05	0.05	0.00	0.00	0.00	0.10

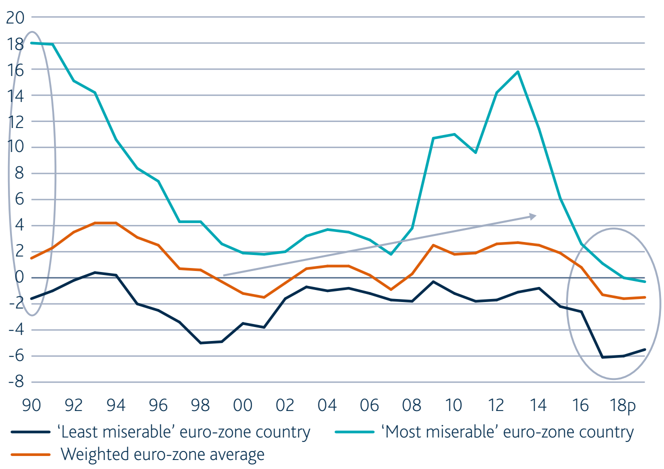
Source: National data, Hermes Investment Management, OECD, & Consensus Economics.

Chart 7. The method & sample data behind our Misery Indices (MIs)
The lower the 'Misery Index', the greater the expected economic improvement

	2018p[1]		Unemployment rates						Misery (p) % point[2, 4]	
	U rate	CPI	2013	'14	'15	'16	'17	5-yr av	2018	2019
Spain	15.5	1.5	26.1	24.5	22.1	19.6	17.2	21.9	-6	-5
Portugal	8.0	1.4	16.2	13.9	12.4	11.1	8.9	12.5	-4	-3
Greece	20.1	0.8	27.5	26.6	25.0	23.6	21.5	24.8	-4	-3
Cyprus	10.0	0.8	15.9	16.1	14.9	13.0	11.3	14.2	-3	-3
Ireland	5.9	1.1	13.1	11.3	9.4	7.9	6.4	9.6	-3	-2
Netherlands	4.2	1.5	7.2	7.4	6.9	6.0	4.9	6.5	-2	-2
Belgium	6.6	1.8	8.5	8.5	8.5	7.9	7.1	8.1	-1	-1
France	8.8	1.5	10.3	10.3	10.4	10.0	9.4	10.1	-1	-1
Germany	3.4	1.6	5.2	5.0	4.6	4.2	3.7	4.5	-1	-1
Italy	10.7	1.2	12.1	12.6	11.9	11.7	11.3	11.9	-1	-1
Austria	5.1	2.1	5.4	5.6	5.7	6.0	5.5	5.6	0	0
Luxembourg	5.7	1.8	5.8	6.0	6.5	6.3	5.6	6.0	0	0
Finland	8.0	1.2	8.2	8.7	9.4	8.8	8.6	8.7	0	-1
Unweighted av	8.6	1.4							-2	-2
Weighted av[3]	8.2	1.5							-2	-2

[1] Standardised unemployment (%), & HICPs (%yoy).
[2] Absolute CPI deviation from 1.9% (+) added to u rate deviation from 5-yr av (+/-).
[3] Using adjusted GDP weights.
[4] Blue shaded areas suggest 'faster than average misery reduction'.
Source: Hermes' MIs, based on Eurostat data, & Hermes, & OECD projections (p).

Chart 8. Divergence between the periphery & core continues to correct
The lower the 'Misery Index', the greater the relative economic improvement



Source: Hermes' MIs, based on Eurostat data, & Hermes, & OECD projections (p).

UNITED KINGDOM

The MPC's window to raise rates may become smaller in 2019, and even close in 2020, keeping liquidity conditions relatively loose. UK growth has almost ground to a halt – from the top of the G5 qoq growth-table in H2 2016 (just after the EU referendum) to the bottom in H2 2017 – despite a softer fiscal stance. CPI inflation is likely to stay above target, not just because of oil, justifying in our view up to two further hikes, to a 1.0% Bank rate. However, these should again be seen as a 'muscle flex', rather than the start of an extended tightening. In the MPC's eyes, it gives them more 'powder' to use, should the economy slow further. But, this is, of course, circular, and the Bank will be mindful that raising rates too far does not cause that downturn!

The MPC's window to hike may become smaller in 2019, & even close by 2020...

Despite trimming their inflation projections in February on a firmer pound and higher bond yields, then in May on a lower perceived pass-thorough to consumers from firms' higher import costs, the MPC now looks set to edge up Bank rate again, to 0.75%. This could come at its next forecast round in August. Their apparent 'flip-flopping' in May, after the softer, weather-affected activity data, again reflects caution. Suspecting that its room for manoeuvre will become more constrained as Prime Minister May seeks a Brexit Treaty in March 2019, it may be putting as much store on tactics as long-term strategy. In the event, a deal as early as March would probably be only as a precursor to sorting out the various legal and trade systems by December 2020.

Also justifying an August hike is doubtless the MPC's assessment of "very little" slack left in the economy, and building excess demand. It will also be hoping that Q1's GDP data is revised upwards (their base case), and that spring's pay settlements data proved strong enough to help validate the traditional link with low unemployment.

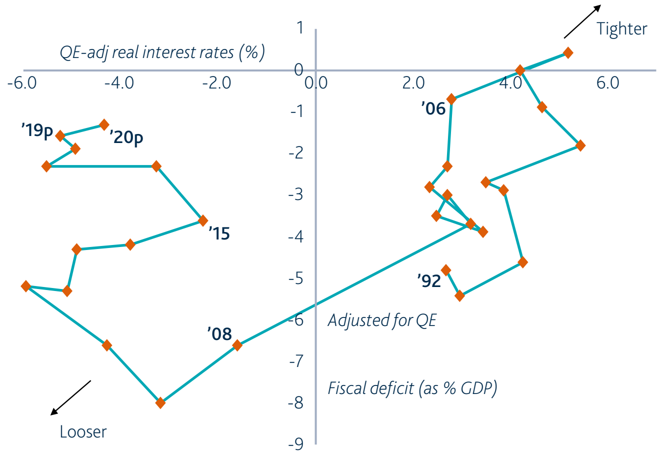
Yet, in the absence of a recovery in real wages – which have for the first time since the 1860s been squeezed for a decade – we doubt they will hike aggressively. The MPC's long-standing hope has been that productivity – which has no more than flatlined since the crisis, delivering the UK's own 'lost decade' – begins to lift from 2018. This would justify higher wage claims and, based on past upswings, would be "a gift for rising living standards" (MPC member, Haldane, March 2017). If it does, they could admittedly then get twitchy fingers.

Economic and interest rate projections (p)

% yoy unless stated	'13	'14	'15	'16	'17	'18p	'19p
Real GDP	2.1	3.1	2.3	1.9	1.8	1.2	1.0
Household consumption	1.9	2.2	2.7	3.1	1.7	1.3	1.1
Fixed investment	3.4	7.1	2.8	1.8	4.0	1.5	1.2
Manufacturing production	-1.0	2.9	0.0	0.9	2.5	1.8	1.0
Retail prices index	3.1	2.4	1.0	1.7	3.6	3.1	3.3
Consumer prices	2.6	1.5	0.0	0.7	2.7	2.6	2.9
Unemp, ILO rate (3m av, %)	7.6	6.3	5.4	4.9	4.4	4.4	4.6
Current account (% GDP)	-5.5	-5.3	-5.2	-5.8	-4.1	-4.3	-4.5
Gen budget balance (% GDP)	-5.9	-5.0	-3.8	-2.3	-2.2	-1.8	-1.6
BoE Bank rate (yr-end, %)	0.50	0.50	0.50	0.25	0.50	1.00	1.00

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

Chart 9. The UK's monetary & fiscal policy mix, adjusted for QE
Using QE-adjusted Bank rate, CPI, & cyclically-adjusted fiscal balance as a % GDP



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

However, two factors that are working against that include inflation, which, barring further sterling declines and/or oil-price increases, may have peaked. BoE staff believe it takes up to four years for higher import prices to be fully passed on to a CPI basket that's about one-third imported. The current shortfall is presumably being cushioned in exporters' margins.

Our simulations show, at current USD/GBP, oil prices, and trade conditions, RPI inflation having peaked at 4.1%yoy last December. Meanwhile, CPI inflation should head up nearer 3%yoy, before trending back down toward (but, at 2.2%, not quite hitting) its 2% target at year-end. These incorporate our two further rate hikes in August and November. But, combinations of a weaker pound and/or higher oil would lift the RPI back toward 4.0%yoy, which, without concomitant pay rises, would again eat into real incomes. In each of these risk-cases, the CPI stays above target this year.

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. Thus we have updated (as we do on page 3 for the US) our 'Policy Looseness Analysis' to gauge how the UK's overall policy position should shift out to 2020.

In chart 9, we incorporate our two further hikes in 2018, and adjust the policy rate for the BoE's 2009 estimate that £200bn in QE was akin to 150bp off Bank rate. Extrapolating the cumulative £445bn QE (including £70bn since the Brexit vote) implies a true, QE-adjusted Bank rate of -2.25% (or down to -5% real). This is much lower than the official rate. On this basis, real rates stay lower than pre-crisis levels.

To keep the lid on rates, the BoE could in tandem whittle away the QE stock. Selling the assets is one for later to minimise the hit to bond markets. But, as a precursor, terminating the reinvestments (or initially tapering them US-style) would surely be the gentlest way of tightening – in effect by 'doing nothing'. It would help keep peak rates low, and give comfort that the BoE is not 'behind the curve'. It may even go some way to reducing belatedly the downside of QE – still evidenced by asset-price distortions, suppressed saving, and funding strains on many pension schemes.

CHINA

With his position entrenched, President Xi's international focus will now be to rebuff concerns about China's alleged anti-globalisation policies, further his Belt and Road initiative, and establish China as a "leading global power" – the latter of which will continue to 'ruffle the US administration's feathers'. Domestically, his strengthened hand allows him too to contain the financial risks flagged up at the past two annual Central Economic Work Conferences. Specifically: of limiting asset price bubbles; taming corporate debt; and managing shadow banking. China's policy landscape could thus change in 2018 – though still not enough, in our view, to derail its underlying growth objectives.

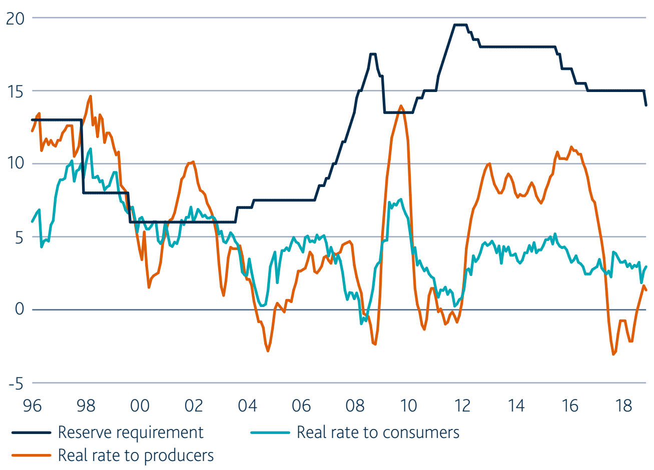
Depreciation, lower reserves, & selective defaults may yet prove damage limitation

These risks remain. By allowing money rates to drift up, the PBoC has compelled banks to rein in credit – especially during the significant, base-driven fall in real borrowing costs as producer-price deflation ended in 2016 (chart 10). For Xi, "The floodgates of monetary supply should be controlled" (December 2017). Property price-inflation has cooled, but 'affordability' (ratio of average house prices to incomes) of 10-30 deteriorated faster than in other world centres. "Houses are meant for people to live in, not for speculation" (October 2017).

These, plus core inflation back up (averaging 2.2%yoy since autumn) could be used to justify gently tighter conditions, and stricter bank supervision by the State Council. Yet, given other goals and trade-sensitivities with the US, expect only a modest tightening cycle, especially if US hikes are tame. Maximising China's growth around the 6½%yoy needed to double 2010's GDP level and per capita income by 2020 should remain the long-term objective. Inflation is monitored, but +3%yoy headline CPI should remain no more than a "predictive target".

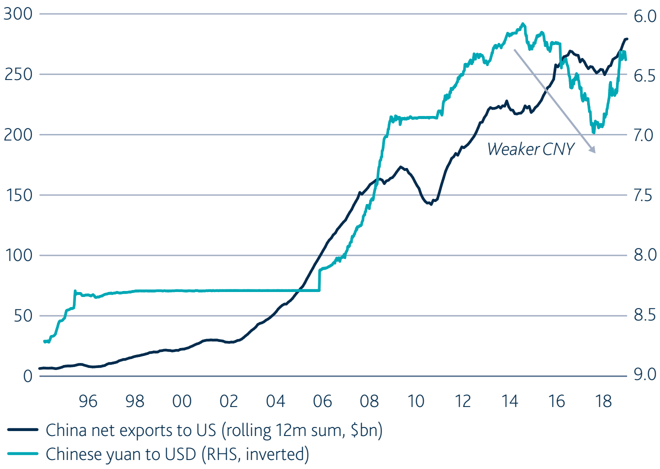
These have been the core aims since 2015, but, growth since has averaged 6.8%yoy. This suggests some wiggle-room to tighten as the PBoC addresses financial risks and continues to 'import' US monetary policy by roughly maintaining its quasi-peg against the USD. The authorities will be wary, that restricting credit too far risks a pervasive slowdown and upsetting the US. So, the effect of allowing policy rates

Chart 10. Less scope now for monetary expansion...
China's 3-5yr lending rate deflated by CPI/PPI, vs RRR for small banks (all %)



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

Chart 11. Weakening the renminbi would be a 'double-edged sword'
China/US bilateral trade surplus, 12m total, $bn. USD/CNY on an inverted axis



Source: Thomson Reuters Datastream.

to follow money rates up could partly offset by another cut in banks' reserve requirements ratios. April's 100bp cut officially aimed at SMEs may have been a 'sweetener' into the US trade talks.

Also, if growth suffers, fiscal policy would be loosened ("cutting business taxes and ensuring incomes"), and, as a last resort, the renminbi allowed to soften. Till then, the concern has been to avoid another haemorrhaging ($1trn between 2014 and early 2017) of forex reserves, and take back some control of the currency, as individuals eat again into their $50,000 per annum outflow limit. Its fall has since been stemmed by capital controls, and higher money rates.

Critically, the RMB has been allowed to fall fastest during bouts of global influence, such as rising US rate expectations in Q4 2015; Brexit fears in Q2 2016; and higher, Trump-inspired US inflation expectations in Q4 2016. The likely persistence of these forces and the risk of protectionism as China's bilateral surplus with the US builds (chart 11), suggest some further possible downside for the RMB.

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

The game-changer could be US trade tariffs. Retaliation by China to any US protectionism could be sought by an inter alia 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. To cushion the indirect blow of a trade war, the PBoC may thus have to slow the pace of depreciation by delving into its $3.1trn reserves. However, we doubt it would act meaningfully to reverse it.

In which case, an uneasy mix of currency depreciation, lower reserves, and selective defaults may yet prove to be 'damage limitation' for Xi, if he can blame it on the US. Either way, his own position now looks enshrined, even beyond the twentieth National Congress in 2022.

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