Economic outlook

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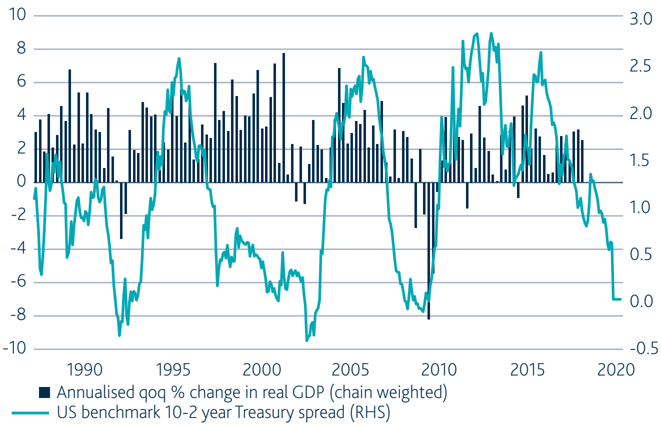
Questioning Goldilocks...

MAIN POINTS

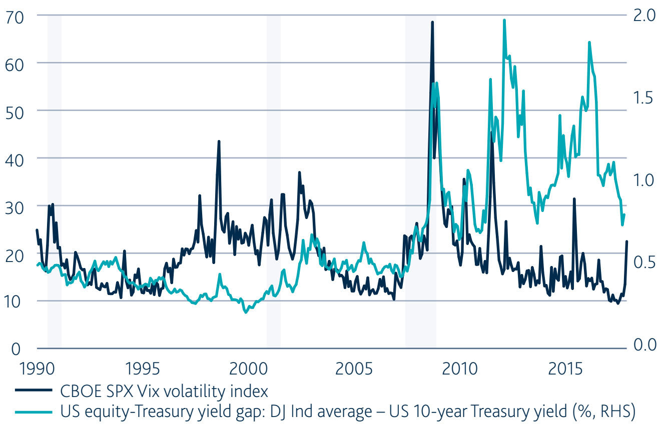
- The recent weakness of equity markets looks driven more by the drift-up in bond yields, US tightening expectations and what they may mean for future growth, rather than any downturn in the economic data. A testament to recovering, rather than relapsing, economies.
- The challenge now for markets questioning the 'Goldilocks' scenario of ever faster growth and ultra-low rates is to identify which of the 'bear' risks to fear.
- Declines from peaks to troughs in equity markets are traditionally associated with macro shocks and/or a toxic policy-mix. But, with policy rates still close to the floor, QE close at hand and little effort on fiscal-deficit cuts, policy can hardly be accused of being toxic.
- Two feasible triggers could be an extension of the bond-yield rise since the US Fed started its 'belt and braces' tightening and a slower China, but these should be contained. Moreover, central banks' 'skin in the game' suggest they cannot take us off guard, which should, more than in other growth recoveries, limit the rise in bond yields.
- The far bigger risk would be a policy face-off between the US and China. US Congress may not be able to preclude President Trump's widespread use of 'Super 301' on countries he deems to engage in "unfair" trade practices. China et al could spark retaliation.
- In which case, 2018 could be a 'year of two halves'. The initial stimulus from Mr Trump's proposed fiscal expansion could gradually become muted by threats of protectionism. US disaffection with the WTO and elections provide extra incentives.
- Should protectionist forces build, inflation will reappear. But, it will be the 'wrong sort'. Central banks will 'turn a blind eye' as economies stagflate, so the inflationary flame may snuff itself out. The disinflationary return to the US could be larger than anticipated.
- Despite a useful reality-check for those expecting 'Goldilocks' to last forever, markets may be fearing the wrong 'bear'. With, in our view, central-bank tightening and bond yields likely to be far less disruptive than the potential new risk emerging, protectionism...

Chart 1. Expectations have been fading that US growth can be sustained US GDP growth with six-quarters lag and 10-2-year US Treasury note spread, bp



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

Chart 2. Helping to take the steam out of elevated equity markets US equity-bond yield gap (using Dow Jones Industrials and 10-yr USTr), vs Vix volatility index



Source: Thomson Reuters Datastream

COMMENT

The recent weakness of equity markets looks driven more by higher bond yields, US tightening expectations and what they may mean for future growth, rather than any noticeable downturn in the economic data. Recoveries are gaining traction with, after a decade, G5 economies having reclaimed their real GDP since the crisis. So, with central banks less dovish, low unemployment fanning hopes of faster wage growth and US tax cuts, the equity falls and volatility pick-up look indirectly, via the bond market, testament to recovering, rather than relapsing, economies (charts 1-2). The challenge now for markets questioning the 'Goldilocks' scenario of ever faster growth and ultra-low rates is to identify which of the 'bear' risks to fear.

Recent moves look a useful reality check, but, is Goldilocks fearing the right bear?

In extremis, declines from peaks to troughs in global equity markets have traditionally been associated with macro shocks and/or a toxic policy-mix (see our Losing sight of the triggers, March 2016). With key policy rates still close to the floor in the US and UK and 'through it' (negative) in the eurozone, Sweden, Denmark, Switzerland and Japan, QE close at hand and little effort on fiscal-deficit reduction, especially in the US, policy can hardly be accused of being toxic.

Certainly there are vulnerabilities. Two feasible triggers could be an extension of the bond-yield rise seen since the US Fed started its 'belt and braces' tightening last autumn (gradual rate hikes and QT) and a slower China, but these should be contained. The US remains the test case for how to normalise rates. We still expect it to try but fail, using QT to take out as many as five rate hikes by 2019 (page 3). This offers chance the US can achieve its longest ever (over 10-years) expansion.

In China, President Xi's strengthened hand allows him to contain financial risk: limiting asset price bubbles; taming corporate debt; and managing shadow banking. With core inflation also back up, this should mean gradually tighter monetary conditions and financial supervision. Yet, while China's policy landscape could change in 2018, it should not be enough to derail its growth objectives (page 7).

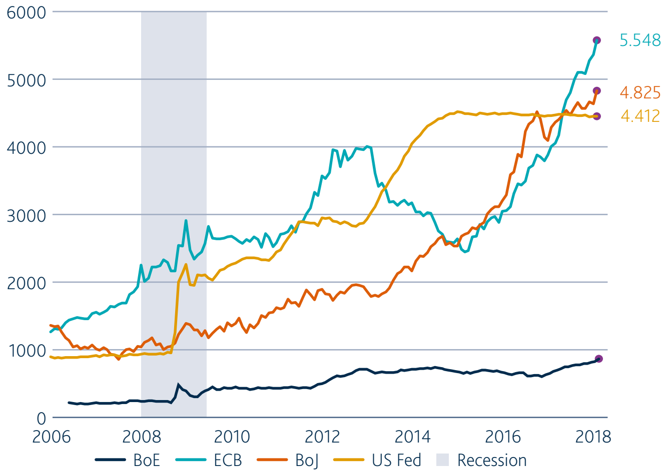
Neither of these should be a shock. Nor should be the pace of normalisation by other central banks, which will continue to be slow. Their frustration is that recoveries since 2009 have been mainly output driven. Unemployment is a reducing drag, but with output gaps slow to close and wage pressure capped, recoveries are failing to generate enough inflation to trigger central banks' usual reaction functions.

Japan's debt dynamics leaves some officials believing the BoJ, after 20 years of easing, will be the last to switch off QE (page 4). The eurozone's still disparate competitiveness means QE, while necessary to fight deflation, should never have been expected to tackle the problem (page 5). The BoE, meanwhile, is about to hike rates for a second time. However, suspecting its room for manoeuvre will become more constrained as PM May seeks a Brexit Treaty by the end of 2019, it may be putting as much store on tactics as long-term strategy (page 6).

This leaves the question after eight years of central bank QE exceeding $15trn of how they can drain the sink without unintended consequences? Their 'skin in the game' (chart 3) and only slow progress thusfar in turning off QE (partly to avoid another 'Taper tantrum' of 2013), suggest they cannot take us off guard. This should in turn, more than in other growth recoveries, limit the rise in yields.

The far bigger risk would be a policy face-off between the US and China. While limiting his ability to impose 'wildcard' measures, US Congress may not be able to preclude President Trump's widespread use of 'Super 301' (Section 301 of the 1974 Trade Act) on countries he deems to be engaging in "unfair" trade practices. Threatened tariffs on steel and aluminium imports and his administration's investigation into alleged intellectual property-rights violations in China look potent first steps and could spark retaliation unless there are new trade talks soon after China's National Congress session in mid-March.

Chart 3. Chasing a 'grand rotation' still means taking on 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

For this reason, 2018 could be a 'year of two halves'. The initial stimulus from Mr Trump's proposed fiscal expansion could gradually become muted by threats of protectionism. US disaffection with the WTO and Trump's need to gain favour into November's Mid-Term elections provide him with extra incentives to play this card.

A run of new central bank heads, at the US Fed, RBNZ, maybe PBoC and ECB and BoE in 2019, will offer new lenses and possibly paradigm shifts. However, any hawkishness would surely be more than offset if we need to brace for the threat of beggar-thy-neighbour policies, still largely unpriced by markets. In which case, without care, an unhelpful jigsaw piece that prolonged the 1930s depression – retaliatory trade protectionism – might yet come crashing into place.

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 demand-pull. Central banks then have to 'turn a blind' eye as economies stagflate. This portends more to the inflation rises of the early 1980s/1990s, than the overheating of the late 1980s/mid-2000s. In which case, the inflationary flame may snuff itself out.

Unhelpfully, the disinflationary return to the US could be larger than anticipated. China could react by inter alia devaluing its currency by more than the around 5% fall implied by forwards for three years time. This would spark depreciations elsewhere (e.g. S.E. Asia, and a renminbi devaluation that hurt China's own balance sheets would question its commitment to US Treasuries.So, while the moves look a useful reality check for those expecting 'Goldilocks' to last forever, markets may be fearing the wrong 'bear'. With, in our view, central-bank tightening and bond yields likely to be far less disruptive than the new risk emerging, protectionism.

UNITED STATES

With GDP-growth running at a fair clip (2.5% yoy and 2.9% ex-government), tax cuts coming, the unemployment rate at a cyclical low and the real GDP-level 15% up on its pre-crisis peak, the short-term outlook remains constructive. The Fed, presiding over a shrunken output gap, perkier wage growth and the second longest, NBER-defined business cycle since 1857 (at almost nine years), remains the test case for whether any central bank can 'normalise' rates. We still expect it to try, but fail – hiking the funds target just two or maybe three times more, probably this March then in other forecast-round months, June and/or September. However, if protectionist forces continue to build, its room to do more will be limited.

Congress would end up blocking the funds needed to support their own approvals...

Five-year inflation expectations have been rising, at about 2.3% yoy, they still seem anchored around the Fed's preferred 2% level and remain no higher than at the start of QE. With the lagged effects of the previous five 25bp hikes to come through (an average 18 months before they fully affect consumer spending), tame core inflation and the threat of protectionism, this should mean a peak rate below the Fed's inferred 3% and the historic average of around 5%.

Equity markets may become increasingly defensive if the focus on tax cuts now shifts more toward protectionism. With his initial fiscal and immigration proposals looking extreme, it was inevitable Congress would push back. But while generally limiting his ability to impose 'wildcard' measures, Congress may not be able to preclude his widespread use of 'Super 301' (Section 301 of the 1974 Trade Act) to enact the more protectionist stance he championed in his campaign.

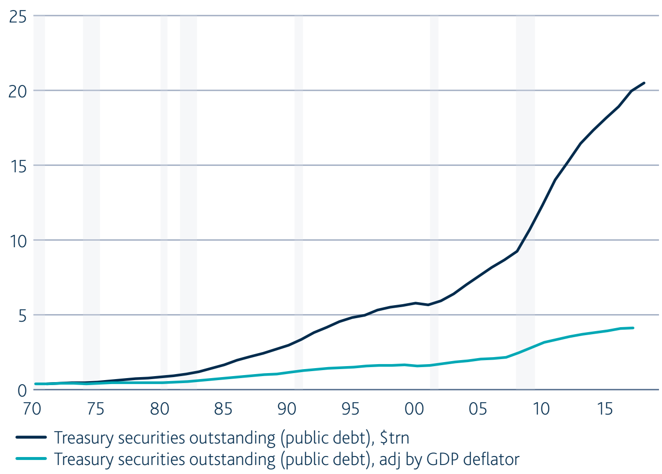
The administration's investigation into alleged intellectual property-rights violations in China looks a potent first step and could spark retaliation unless there are new trade talks. While not widely used since the WTO's formation in 1995, US disaffection with the WTO and Trump's need to gain favour into November's Mid-Term elections offer extra incentives to play this card. In the event, Republicans should be able to retain their majorities in both chambers. But, their only single-seat majority in the Senate and the encumbrance to some district candidates of the President's erratic decision-making suggest there's little room for complacency, even with the tax cuts.

Economic and 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	2.7	1.8
Personal consumption	1.5	2.9	3.6	2.7	2.7	2.8	1.9
Business investment	3.5	6.9	2.3	-0.6	4.7	5.2	4.0
Industrial production	2.0	3.1	-0.7	-1.2	2.0	2.8	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	-3.7	-4.5
Funds target (yr-end, %)	0.25	0.25	0.50	0.75	1.50	2.00	2.00

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

Chart 4. US Treasury debt outstanding, in nominal and real terms.
US Treasury securities outstanding ($trn). Grey blocks denote US recession



Source: Thomson Reuters Datastream, based on US Department of the Treasury

While confidence is high, euphoria over Trump's long-term fiscal reform (initially proposing $4trn over the decade, or 22% of GDP) should begin to wear off. He had hoped his first step, $100-120bn of tax cuts in 2018, mainly via corporate and personal tax changes, would add a 1%point to full-year GDP growth, but this may be optimistic. The corporate tax cuts are mainly for ex post, rather than ex ante capex plans and job creation may be limited so close to full employment.

As a guide, our simulations suggest a Fed determined to follow through on its preferred 3% funds rate would over three years fully offset any 1%point growth-boost. The new, Fed Chair, Powell, will obviously be keen to assert his authority. However, he should be seen as a continuity hire, having spent five years as Fed Governor supporting Yellen's only cautious hikes. It remains to be seen, though, whether he and the new Vice-Chairs resit lightening bank regulation.

By contrast, the so-called 'Taylor Rule' currently pitches the Funds target as high as 4%, assuming a 5% NAIRU; or closer to 3% if the NAIRU matches the FOMC's expectation for unemployment around 4% to 2019. FOMC members have so far, helpfully, been ignoring this rule. By taking account of QE, the Fed's planned QT and also the fiscal outlook, our Policy Looseness Analysis offers a broader alternative. (See our US Fed – addressing the balance sheet report, August 2017)

It suggests: (i) the true funds rate is closer to -4%, or about -6% in real terms, when adjusting for the FOMC's previous trade-off that $600bn of QE is equivalent to an around 75bp off the Fed funds rate; (ii) assuming symmetry for QT, the Fed could by sustaining its new 'non re-investment' programme 'take out' as much as 130bp of rate hikes by 2019; and (iii) given these assumed trade-offs, the process of interest-rate normalisation will be slower than many expect.

Further disruption, meanwhile, may have been deferred by Congress' suspension of the debt ceiling till next February – after the Mid-Terms. 'Default' here is likely, of course, only via inflation, but it could resurface if the ceiling is not raised beyond the $20trn (108% of GDP) now outstanding (chart 4). If it isn't, Congress would end up blocking the funds needed to promote their own approvals. And, if akin to prior government shutdowns such as August 2011, equities and sovereign ratings would doubtless suffer.

JAPAN

Despite more enduring growth, Japan's authorities still have every incentive to prolong a policy loosening entering its twentieth year. Economic activity is picking up. In real terms, GDP (growing 1.5% yoy in Q4 2017) has for the first time since the early 1990s asset-price collapse been rising for as many as eight consecutive quarters. This reflects better external demand, a weaker yen and, linked to that, successive rounds of monetary and fiscal stimuli. Yet, Japan's 'Holy Grail' – the end of deflation – is still not assured. Expect minimal, if any, true unwinding of QE in FY18 (year ending March 2019) and a continuation through Abe's likely tenure to 2021 of his 'three-arrows' – of a looser monetary stance, expansionary fiscal stimulus and structural reforms (labour market, corporate governance).

Expect minimal, if any, slowing of QE, which is now directed at the yield curve...

There are no counterfactuals, but with wages still muted and the deflationary psychology entrenched, payback has so far been limited. Governor Kuroda has for the fifth time extended (to FY19) the BoJ's pledge to hit its +2% yoy CPI target. This takes pressure off him in April as he starts his second term, but guarantees an expansionary monetary stance throughout his and Abe's tenures.

The latest form is the BoJ's targeting since April 2016 of a near-zero yield on 10-year JGBs, amid even lower short rates. 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%.

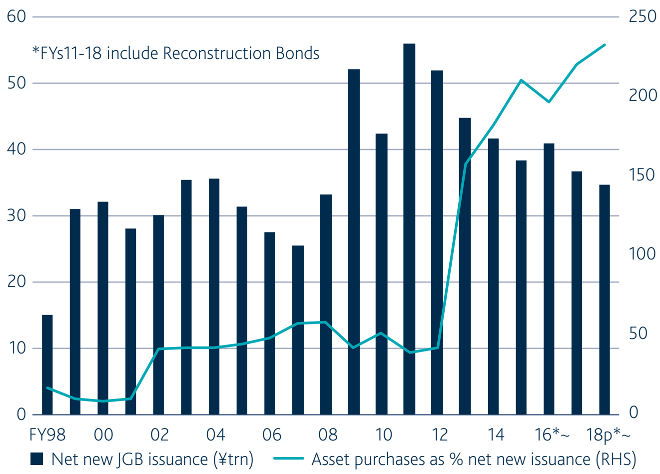
Yet, this catch-22 precludes the BoJ from switching off, or – without sustained inflation to erode the real value of the debt – cutting back on its QE. At ¥80trn per annum ($708bn) in total asset purchases – the vast bulk being JGBs, the rest ETFs and REITs – it's been mopping up JGBs at twice the pace of net supply (chart 5). Depending on where global yields go, though, this ¥80trn may now vary depending on how much QE is needed to meet the around 0% yield target. So, any fall should not been seen as a 'normalisation' or QT. For Kuroda, there is no QE "reversal" till 2% CPI inflation becomes the norm.

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	4.6	2.7	1.9
Consumer prices	0.3	2.7	0.8	-0.1	0.5	0.7	1.7
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	-5.0	-4.0	-3.8
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 and Consensus Economics

Chart 5. BoJ will probably again buy a record share of JGBs. Net new JGB supply (¥trn) and BoJ asset purchases as % total on RH scale



Source: Hermes, based on MoF and BoJ. (~NB: FY18 assumes unchanged rate of QE)

Under him, 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 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.

This deflationary psychology has also constrained wages and asset prices. 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 the US's.

This spring's annual wage-round (shunto) will again be telling and hopefully perkier than the +2% average one-off wage hikes in each of the 2014-17 rounds. These were not sustained and political pressure on firms to raise wages will continue. 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 excessive profits more than wages and be offset by the higher-end tax rises planned for FY20.

Encouragingly, though, land prices, after falling for 25 years, are now stabilising. 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 again in 2014 and the BoJ in 2000 ended its zero rate policy. Each time, they had to back-track as consumption slumped.

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 thus a gamble and may have to be diluted by fiscal offsets. 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 last two hikes together. But, more importantly, based on the experience since the last tax rise in 2014, it's doubtful that another one would be any different this time – in terms of igniting wages and much-needed inflation expectations.

EUROZONE

With GDP-recovery gaining pace, the worst of the Eurozone's macro strains look behind us – helped as the lagged effects of ultra-low rates and yields from three years of sovereign QE flow through to increased consumer/business confidence and higher loan demand. But, while helpful in addressing the symptom, deflation, Mr Draghi's monetary measures could never have been expected to solve the underlying problem – a monetary union devoid of economic union. This will take years. So, with this in mind, we update our long-standing Competitiveness Analysis to show the progress so far.

The eurozone's competitiveness gap is narrowing, but will take years to close...

We use the OECD's latest estimates to the end of 2017 and projections to 2019 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.

First, as an amorphous bloc, the eurozone is after seven years of austerity regaining competitiveness lost since the euro. Only part of this can be laid at the weaker euro's door (a net -7% in trade-weighted terms). The zone's costs between 2000 and 2009 rose a net 20% relative to its trading partners. This compared with falls of 19-20% 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 18% in the US and the UK's 6% fall. If sustained, it suggests further relative gains in eurozone exports.

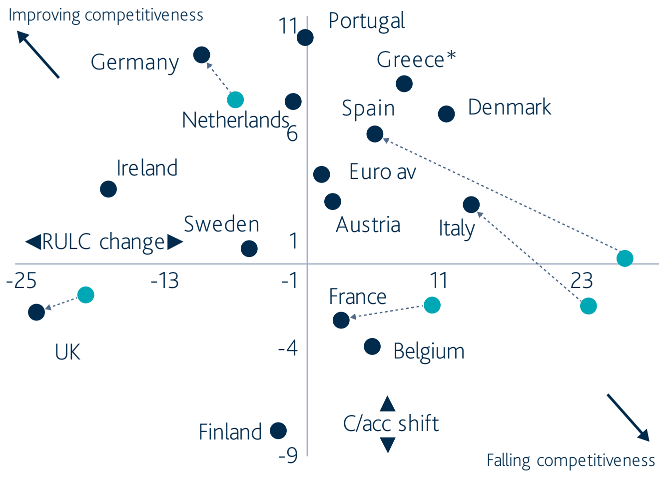
Yet, despite this overall improvement, shifts in individual members' competitiveness are still too disparate. Chart 6 shows the absolute competitiveness-shifts by country from 2000 to 2017. With the escape route of currency devaluation closed off, the deciding factor has been whether members undertake 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 eurozone GDP. Germany saw its unemployment rate rising from under 8% in 2001 to over 11% by 2005. Still, this reaped dividends and it has since translated cost control into substantial current account improvement.

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	3.0	4.5	3.5	3.3	3.0
Industrial production	-0.7	0.8	2.1	1.5	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	3.1	3.0	3.0
Gen budget balance (% GDP)	-3.0	-2.6	-2.1	-1.5	-1.3	-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 and Consensus Economics

Chart 6. Competitiveness within the eurozone 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)

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.

However, 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 2017 in green thus suggest improvement. Outside the zone, the UK since 2000 has managed to outperform by virtue of sterling's 22% depreciation – a route cut off to eurozone members.

But, this comes at significant economic and social cost, suggesting stimulus will still be 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.

After impressive gains, there's a limit to how far Spain and Italy can reform, given male youth unemployment rates of 37% and 33%. Their real household spending are still 3-5% down on 2008, yet Germany's is 11% up. Then there's Greece, whose deflation improved competitiveness, but exacerbated its real-debt dynamics. After losing 25% of real GDP since 2010, it too has reform fatigue.

So, tackling the problem always needed more than QE. Encouraging now are Germany's likely, higher wage-settlements for 2018 and 2019, following IG Metall's +3.5% for each. These lie above the 2% norm and average 2.8% projected by the Buba. The issue then is whether they cut competitiveness and aid convergence – this time from Germany's side – or just get offset by higher unemployment.

UNITED KINGDOM

Despite trimming their inflation projections on a firmer pound and higher bond yields, the BoE looks set to edge up Bank rate again, to 0.75%, probably at its next forecast round in May. As with the move last August (the first since July 2007), its careful telegraphing again reflects caution. Suspecting that its room for manoeuvre will become more constrained as PM May seeks a Brexit Treaty by the end of 2019, it may be putting as much store on tactics as long-term strategy. Justifying a move in May are the MPC's assessment of"very little" slack left in the economy and building excess demand. It will also be hoping that spring's pay settlements data are strong enough to help validate the traditional link with low unemployment (chart 7).

Given Brexit, the MPC may be putting as much store on tactics as strategy...

Yet, their window to hike may become smaller into 2019. UK growth is already slowing – from the top of the G5 qoq growth-table in H2 2016 (just after the referendum) to the bottom in H2 2017 – despite a softer fiscal stance. With CPI inflation likely to fall back, the (only) two further hikes we expect, to a 1.0% Bank rate, 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 rate '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!

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.

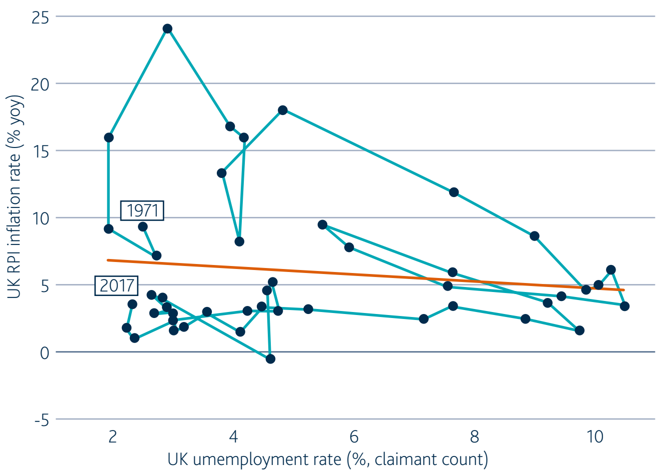
However, two factors working against that include inflation, which, barring further sterling declines and/or oil-price increases, may have peaked. BoE staff believe it takes up to four years for higher import prices to be fully passed on to a CPI basket that's about one-third imported. Some suggest pass-on has been milder than expected (about 40% as of last summer), with the shortfall presumably still being cushioned in exporters' profit margins.

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	1.6	1.3	1.1
Fixed investment	3.4	7.1	2.8	1.8	2.8	1.5	1.2
Manufacturing production	-1.0	2.9	0.0	0.9	2.8	1.6	1.0
Retail prices index	3.1	2.4	1.0	1.7	3.6	2.8	3.2
Consumer prices	2.6	1.5	0.0	0.7	2.7	2.4	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	-4.5	-4.2	-4.5
Gen budget balance (% GDP)	-5.9	-5.0	-3.8	-2.3	-2.4	-1.9	-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 and Consensus Economics

Chart 7. The BoE seeks a re-emergence of its usual reaction function. UK fitted 'Phillips curve', showing trade-off between unemployment rate and inflation



Source: Thomson Reuters Datastream, based on ONS data

Should the pound fall and/or protectionism build, inflation will rebuild. Our simulations show, at current USD/GBP, oil prices and trade conditions, RPI inflation having peaked at 4.1% yoy; while CPI inflation heads to its 2% target (just) at year-end. These incorporate our two further rate hikes, in May and November. But, combinations of a weaker pound and/or higher oil would lift the RPI toward 5.0% yoy. This would be a six-year high. In each risk-case, the CPI stays above target this year, with further GBP weakness/oil gains lifting it to +3.5% yoy.

Still, this would be the 'wrong sort': cost-push, rather than 'feel-good' demand-pull. This portends more to the inflation rises of the early 1980s/1990s UK recessions, than the overheating of the late 1980s and mid-2000s. In which case, the inflationary flame may snuff itself out. Even if the worst of Brexit is priced in, the pound probably has limited upside. Our analysis suggests no major economy has in the long-term net loosened its overall (monetary and fiscal) stance more than the UK. Given the inflation premium, there's little coincidence those running expansionary policies sustain the weaker currencies.

The Bank in theory has another lever to pull if it wishes to cap the rise in Bank rate, by winding down its £445bn balance sheet (£335bn gilts, £10bn corporate bonds). As a guide, we estimate the trade-off from peaking out at today's still historically low Bank rate would over time be to wind down almost half their QE-bought bonds. Selling these assets back is one for later. Nonetheless as a prelude, tapering the Bank's reinvestments – US Fed-style – would mean they could 'tighten by doing nothing'.

So, while nudging rates up, the Bank will want to keep monetary policy accommodative, yet minimise disruption via further (hawkish) telegraphing. But, this is where policy credibility may be questioned. As a guide, the MPC's more benign forecast last August seemed to reflect inter alia the extra rate hike assumed by money markets that had been triggered by the MPC's own messaging! By promising to hike "somewhat earlier and by a greater extent" than he expected before Christmas, governor Carney probably needs to deliver. Especially if Chancellor Hammond in his Spring Fiscal Statement on 13 March does not bring forward his vague intention to return to fiscal surplus "...sometime in the next Parliament", scheduled for 2022/23.

CHINA

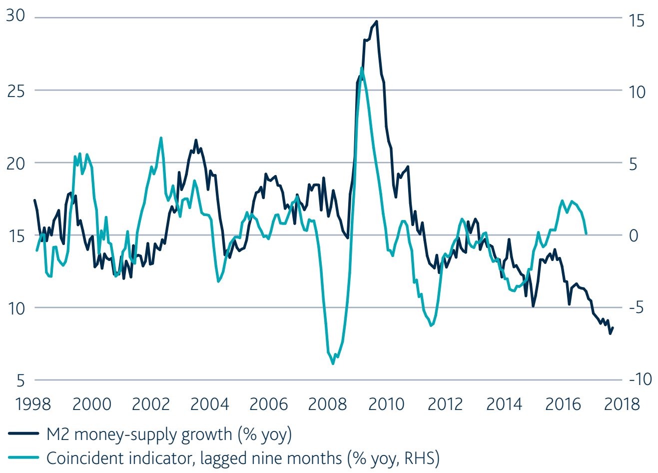
With his position entrenched and a mention in the Constitution, President Xi has become the Communist Party of China's (CPC's) most powerful leader since Deng Xiaoping up to 1989 and before him, Mao. This, plus March's likely confirmation of Li as Premier, offer stability even beyond the twentieth national congress in 2022, when at 69 years old, Xi would previously have been expected to stand down. Xi's international focus will now be to rebuff concerns about China's anti-globalisation policies, further his Belt and Road initiative and establish China as a "leading global power". While domestically, he will continue to put politics and Party first, as expressed since 2002.

The renminbi is a double-edged sword. It may be weakened, but only reluctantly...

But his strengthened hand allows him to contain the financial risk flagged up at the past two annual Central Economic Work Conferences. Specifically: of limiting asset price bubbles; taming corporate debt; and managing shadow banking. With core inflation also back up (averaging 2.2% yoy since autumn), this should mean gradually tighter monetary conditions and stricter supervision by the State Council. China's policy landscape could thus change in 2018 – though not enough, in our view, to derail its underlying growth objectives.

Expect only a modest tightening cycle, especially if US hikes are tame. By allowing money rates to drift up, the PBoC has for over a year compelled banks to rein in credit."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. For Xi, "houses are meant for people to live in, not for speculation" (October 2017).

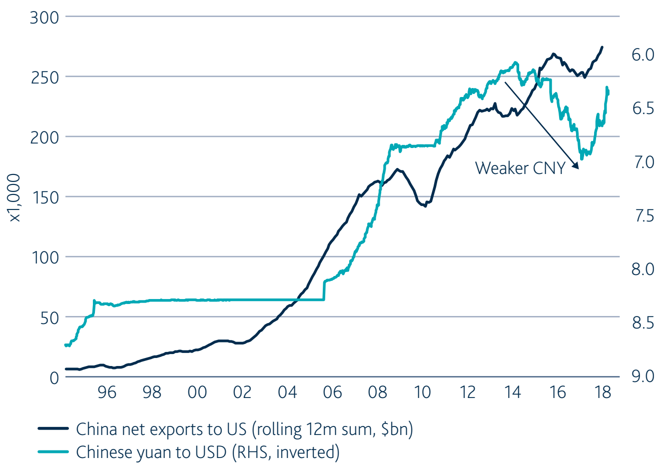
Chart 8. More slowing to come? Shows coincident indicator (lagged 9 months), vs M2 money-supply growth (% yoy)



Source: National Bureau of Statistics and People's Bank of China

Yet, maximising growth "around the 6½% yoy" needed to double 2010's GDP level and per capita income by 2020 and employment should remain the CPC's long-term objectives. This has been the core goal since 2015 and growth since has remained higher, suggesting room to tighten. The authorities will be wary that restricting credit too far risks a pervasive slowdown (chart 8). So, banks' reserve requirements may be raised (the first time since mid-2011) and policy rates allowed to gently follow money rates up – as the PBoC addresses domestic issues and continues to 'import' US monetary policy by roughly maintaining its quasi-peg against the USD "at a reasonable equilibrium level".

Chart 9. Weakening the renminbi would be an imperfect pressure release. China/US bilateral trade surplus, 12m total, $bn. USD/CNY on an inverted axis



Source: Thomson Reuters Datastream

Should the economy suffer, 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.

Tellingly, though, 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 9), thus suggest some further possible downside for the RMB.

As long as 'free' trade continues, this should be gradual. 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.

However, the game-changer could be US trade tariffs and it remains to be seen how more combative US/China relations become over N. Korea. Retaliation by China to any US protectionism could be sought by inter alia a devaluation that clawed back some of the competitiveness-hit. This in turn risks imploding China's corporate and banks' balance sheets most exposed to USD debt and, to cushion the impact, the PBoC having to delve into its $3.1trn reserves.

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. Slower world trade would then make it easier to explain any domestic growth shortfall.

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