

OUTCOMES
BEYOND
PERFORMANCE

ECONOMIC OUTLOOK

Japanification...

Neil Williams
Senior Economic Adviser

Hermes Investment Management
Q3 2019

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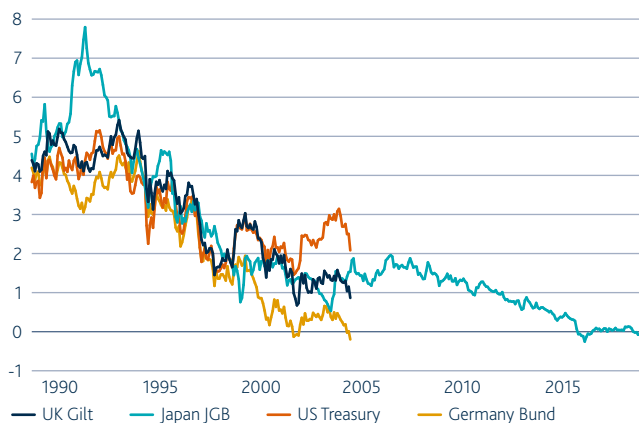


MAIN POINTS

- ▶ Political risk is ‘trumping’ economics, with populism, disparate prosperity, and stirrings that globalisation needs to reverse all offering a paradigm shift that may prove as forceful as the fall of communism in 1989, and even the New World Order after 1945.
- ▶ Policy-makers ‘playing King Canute’ look ill-equipped to deal with this. With their traditional reaction-functions having broken, central banks are already turning dovish again. This makes comparisons with Japan – approaching its twenty-second year of policy loosening without convincing inflation – more than just a coincidence.
- ▶ This does not bode well for other economies. Bloated asset prices are a result of QE. But, they’re also a reason why, in a more febrile political climate, QE cannot be reversed, for fear of losing the baby (recovery) with the bath water. So, the spoils will continue to centre on those (asset owners) that probably need it least.
- ▶ Markets are now sensing Japanification. Germany’s bank margins are under pressure from negative rates, with some describing the euro-zone as “overbanked”. An ageing demographic, labour rigidities, and pressure to devalue internally are other worrying comparators between core euro members and Japan.
- ▶ Differences exist, but these are not reassuring. Japan in the late 1990s was acting alone, with overheating being the G7’s main concern. Since 2008/09, they have acted swiftly and in concert to achieve similar goals. Yet, their inflation outlook is no more convincing. Japan benefited from social cohesion, contrasting with the disruption and growing populism in the US and Europe.
- ▶ In policy terms, there seems to be two common threads. First, that the QE-drug can be difficult to kick. The last time proper was the US pulling out of the 1930s depression. Then, QE ran for 14 years to 1951, despite double-digit inflation touching 20% in 1947. A different time, but, if it’s a guide, we may be little more than half-way through our QE.
- ▶ Secondly, that prolonging cheap money reduces central banks’ armouries, diluting their ability to affect change. The dilemma is now whether they can re-equip themselves for future downturns, or – like Japan – preserve the status quo. Their ‘skin in the game’ suggests the latter.
- ▶ In which case, with the yield-clamp of QE in place, governments trying to preserve growth and appease disaffected electorates may as well do something that justifies it. Time to open the fiscal box....

Chart 1. Is Japan leading the way? QE is continuing to cap bond yields...

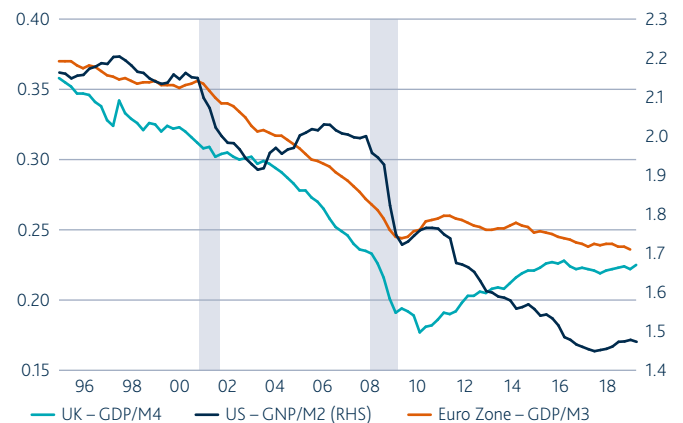
Ten-year JGB yields, vs 10-year US Treasury, Bund, & UK Gilt yields, each lagged 15 years



Source: Thomson Reuters Datastream

Chart 2. But, its transmission mechanism has been less than perfect...

Estimated money velocity: ratios of nominal GDP to broad money supply. Grey is US recession



Source: Thomson Reuters Datastream, based on national data



COMMENT

Political risk is 'trumping' economics, with a confluence of factors such as populism, disparate prosperity exacerbated by a decade of QE, and stirrings that globalisation needs to reverse, offering a paradigm shift that may prove as forceful as the fall of communism in 1989, and even the New World Order after 1945. Policy-makers 'playing King Canute' look ill-equipped to deal with this. Failure to normalise monetary policy leaves central banks scared of their own shadows, and governments ready to expand fiscally. The Holy Grail remains wage-growth. So, with their traditional reaction-functions (e.g. CPI-targeting) broken, central banks are already turning dovish again. This makes comparisons with Japan – approaching its twenty-second year of policy loosening without convincing inflation – more than just a coincidence.

Comparisons with Japan are more than a coincidence...

As a result of their asset purchases, the world's big four central banks' balance sheets have in total ballooned to \$15trn. This liquidity injection to the private sector is equivalent to about three quarters of US GDP, one and a quarter times China's, or about six times the UK's. It means that about one half of the world's \$26trn central bank assets has amassed in just 10 years. That is, since the US recession ended in mid 2009. Lacking inflation, the BoJ, ECB, and BoE are all keeping their QE sinks full, believing it's the QE stock that matters. Even the US Fed, after four years of inching rates up, is about to put the plug back in. It is the test-case for others on normalisation, and failing to do so (page 3).

Early QE unclogged the system: providing liquidity, keeping yields down, and yield curves steep. It loosened the monetary reins when rates were already on the floor. In fact, the loosening has probably been underestimated, given that the 'Taylor Rule' used by the Fed does not explicitly track QE. When we factor it in, the US (page 3) and UK (page 6) are still running negative policy rates. Even so, QE's transmission mechanism has been woefully slow. The responsiveness of GDP to money-growth has been less than the one-to-one hoped-for, as consumers/producers wary of unemployment and deflation became interest-rate insensitive.

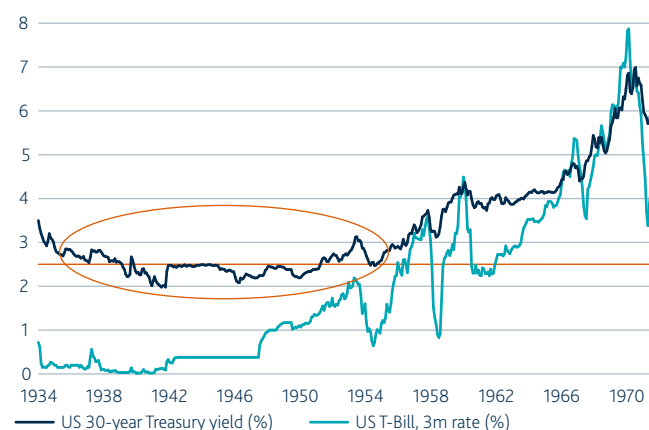
Economics students will remember Fisher's 'quantity of money', where $MV=PT$. The impact of a money stimulus (M) on GDP (PT) will be quantified by the speed (V) at which agents push money round the economy. In reflation terms, it's no good throwing money out of a helicopter if no-one spends it. In practice, with consumers and firms in a liquidity trap, velocity has been slow to recover (chart 2). Only in the UK, helped by housing's sensitivity to low short rates, is velocity rising. Critically, the fact that GDP and money-growth were lacking until about 2012 suggests the inflation QE spawned came more by inflating asset prices, than the direct, consumer route hoped for in 2009. By running cost, rather than demand-inflation, QE has come to act more like a tax than a subsidy. And as demand stuttered, central banks turned on more QE, thus creating a vicious circle that now aren't be broken.

Much of this has precedent in Japan. There, asset prices in the late 1980s were ballooning – stylised by the valuation of the Emperor's palace grounds (at \$139,000 per square foot) surpassing that of California's total real estate. A strong yen (exacerbated by the 1985 Plaza Accord to weaken the US dollar), and deflation-denial as the BoJ tightened contributed to a correction that's still playing out. Tumbling asset prices from 1991 hurt banks' balance sheets and collateral, contributing to economy-wide deflation by 1995. This prompted banks to write off loans, and the BoJ in 1997-98 to mop up their commercial paper ('QE1').

The BoJ took until 2001 to get its key policy rate down to 0.1% but, with deflation expectations embedded and land prices falling, real rates stayed positive. This needed more unconventional tools, including JGB QE. A symbiosis started where the MoF, presiding over escalating government

liabilities, became reliant on the BoJ to control debt-service costs. Caught in a liquidity trap, only in 2007 did Japan recoup its pre-1988 nominal GDP. This then proved temporary into the 2008/09 global crisis.

Chart 3. Meaning QE – as in the 1930s – will be no 'flash in the pan'
Shows US 30-year Treasury yield, & three-month Treasury bill rate (both %), 1934-1971



Source: Thomson Reuters Datastream, & US Federal Reserve Board

This does not bode well for other QE economies. They've taken between four and nine years to re-claim pre-crisis GDP levels; their inflation expectations are low even after 10 years of pump-priming. And as we know from Japan, the only real benefit is to support asset prices and keep bond yields low (chart 1). Bloated asset prices are a result of QE. But, they're also a reason in a febrile political climate why QE cannot be reversed, for fear of losing the baby (recovery) with the bath water. So, the spoils will continue to centre on those (asset owners) that probably need it least.

It also leaves central banks as monetary agents for governments, questioning independence. The US Fed and ECB have gently switched off the tap. But, the former is stopping QT after just two years, while the latter continues to reinvest coupons and maturing bonds. Markets are thus, rightly, sensing Japanification, with bond yields in Germany now lower than Japan's. Like Japan, Germany's bank margins have been under pressure from negative rates, and some ECB officials are describing the euro-zone as "overbanked". An ageing demographic, labour rigidities (regulation, annual wage bargaining), and pressure to devalue internally are other worrying comparators between core euro members and Japan.

Differences exist of course, but even these are not reassuring. Japan in the late 1990s was acting alone, with the US recession-free until 2001, world growth up to 4.5%yoy (versus 3% now), and overheating rather than recession being the G7's main concern. Since 2008/09, they've acted promptly and in concert to achieve similar goals. Yet, the inflation outlook is no more convincing. Japan benefited from social cohesion: the LDP ruling for all but three of the past 64 years, including 1955-2009. This compares with disruption and growing populism in the US/Europe.

In policy terms, there seems to be two common threads. First, that the QE-drug can be difficult to kick. The last time proper was the US pulling out of the 1930s depression (chart 3). Then, QE ran for 14 years to 1951, despite double-digit inflation touching 20% in 1947. This was of course a different time. But, if it's a guide, we may be little more than half-way through our QE. And, secondly, that prolonging cheap money reduces central banks' armouries, diluting their ability to affect change. The dilemma now is whether they can equip themselves for future downturns, or – like Japan – preserve the status quo. Their 'skin in the game' suggests the latter.

In which case, with the yield-clamp of QE already in place, governments trying to preserve growth and appease disaffected electorates may as well do something that justifies it. Time to open the fiscal box.



UNITED STATES

After less than four years, the Fed’s attempt to ‘normalise’ policy rates – the test case for all central banks – is failing, with the funds target rate looking at, or very close to, its summit. Even if it surprises markets by raising rates again, this would still leave the official rate barely positive in real terms. Perkier wage growth, a shrunken output gap, and what, at more than a decade, is about to become the US’s longest (NBER-defined) business cycle since 1857, have all justified tightening. However, with five-year inflation expectations still no higher than at the start of QE, they remain sufficiently anchored to the Fed’s preferred 2% level that faster wage-growth (averaging 3% in 2018) can be tolerated. Should protectionism build, the FOMC may have to start easing rates again in 2020 to avoid recession.

At the summit: ‘normalisation’ has failed...

Meanwhile, the Fed can afford to be “patient” (FOMC Minutes, 1 May). With mortgage rates typically priced off the long Bond, the almost 50bp yield-fall since the latest Fed hike last December should satisfy those looking for an earlier rate cut. The unemployment rate may settle around its 50-year low (3.6%), but typically lags output, and, as Fed Chair Powell cautions, may not steepen the flat Phillips curve. With the lagged effects of at least four of the previous nine quarter-point rate rises also yet to come through (taking an average 18 months before they fully affect consumer spending), within-target core inflation and the threat of protectionism, this should confirm a peak rate no higher than the Fed’s until recently inferred 2.75%, and historic average 5%.

Under some assumptions, the ‘Taylor rule’ currently pitches the funds target as high as 3.5% if the non-accelerating inflation rate of unemployment (NAIRU) lies close to the average 3.8% actual unemployment rate the FOMC expects to 2021. Yet, by taking account of QE, planned QT, and the fiscal outlook, our ‘Policy Looseness Analysis’ suggests a true funds rate closer to -1.5%, or around -3.5% in real terms. (See our Tightening by doing nothing report (May 2017) for more.) It confirms that the Fed will fall easily short of taking the de facto real policy rate back to its pre-2008 levels, with the fiscal expansion providing an additional support to growth.

Our analysis incorporates the Fed’s even more dovish QT plans released in March (chart 4). QT is now expected to be phased out, then stopped, in October. This implies a near halving of QT in 2019 (from \$600bn to \$375bn) compared to sustaining it at the current pace. On the basis of the Fed’s own QE trade-offs (and assuming symmetry for QT), this \$225bn QT-saving is itself equivalent to a de facto 25bp rate cut. It reinforces the loosening effect of (if sustained) the lower Bond yield. Chart 5 goes further by mapping the overall (monetary and fiscal) stimulus relative to the output gap. Stimulus is gauged by how far the combined position lies from its long-run average. It’s plotted as a negative on the axes. As policy ‘normalises’, the points should edge back to the vertical axis, as recovery warrants stimulus removal.

Chart 5 suggests the economy would need as much as 500bp-worth of extra tightening from another source if the FOMC is to peak out at 2.75%, and still allow overall policy to reach ‘neutral’. A sharp fiscal contraction looks improbable into the 2020 presidential election, putting onus on QT to fill the gap. Yet, by our estimates, the extra \$4trn QT required to move to neutrality would wipe out the Fed’s balance sheet. This is contrary to plan, and equally unlikely. So, with rate normalisation ending, neutrality could, in theory, be reached by pulling on other levers. Yet, the practical hurdles (FOMC thinking, growth and political risks) suggest the gap will have to stay open – leaving US macro policy loose for much longer yet.

Economic & interest rate projections (p)

% yoy unless stated	'14	'15	'16	'17	'18	'19p	'20p
Real GDP	2.5	2.9	1.6	2.2	2.9	2.3	1.2
Personal consumption	2.9	3.7	2.7	2.5	2.6	2.3	1.5
Business investment	6.9	1.8	0.5	5.3	6.9	4.0	2.4
Industrial production	3.1	-1.0	-2.0	2.3	4.0	2.1	1.4
Consumer prices (nsa)	1.6	0.1	1.3	2.1	2.4	2.0	2.6
Unemployment rate (%)	6.2	5.3	4.9	4.4	3.9	3.6	3.8
Current account (% GDP)	-2.1	-2.2	-2.3	-2.3	-2.4	-2.2	-2.0
Fed budget balance (% GDP)	-2.7	-2.6	-3.1	-3.4	-4.2	-4.4	-5.0
Funds target (yr-end, %)	0.25	0.50	0.75	1.50	2.50	2.50	2.25

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

Chart 4. The US Fed’s now more dovish QT (‘non re-investment’) plans

US Fed’s Balance Sheet Normalisation Principles & Plans, & Hermes estimates*

QT 2017-19	Potential non-re-investment (\$bn per quarter)	*Equivalent rate hike (Full year, bp, rounded)	
2017 Q4	30	= 3x \$10bn p/m	5
2018 Q1	60	= 3x \$20bn p/m	
2018 Q2	90	= 3x \$30bn p/m	
2018 Q3	120	= 3x \$40bn p/m	
2018 Q4	150	= 3x \$50bn p/m	50
2019 Q1	150	= 3x \$50bn p/m	
2019 Q2	120	= \$50bn + 2x \$35bn	
2019 Q3	105	= 3x \$35bn	
2019 Q4	0	–	50
Total =	825		105

Source: Hermes Investment Management*, based on US Federal Reserve, March 2019

Chart 5. Quantifying just how loose policy will stay relative to the recovery ((QE/QT adj real rate – its long-term avg) + (cyc adj fiscal bal as % GDP – its long-term avg))



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

JAPAN

Despite being *in situ* probably until his final term ends in August 2021, PM Abe has every incentive to prolong a policy loosening spanning over 20 years. Activity had been building: real GDP until the end of CY17 rose for nearly two years – the joint longest stretch since the 1990s' asset-price collapse. In addition, the output gap closed – suggesting a return, if growth could be sustained above its 1%yoy 'potential' rate, to economy-wide inflation (positive GDP-deflator). This reflected better external demand, a weaker yen, and successive rounds of monetary and fiscal stimuli, but, these are losing their edge. With personal consumption falling into October's likely sales-tax rise (contrary to its front-loading into 1997 and 2014's hikes) and looming trade hurdles threatening the auto sector, deflation's-end is still not assured.

Extending 20 years of policy loosening...

Abe's call for a third tax hike (from 8% to 10%) is a gamble ahead of July's Upper House and 2021's Lower House elections. If he wants to back-track (risk case), he may be tempted to call snap elections. Yet, abandoning it would forego a near one-for-one lift to the CPI, and rob the MoF of its part in a ¥13trn (2% of GDP) revenue-take from the 2014 and 2019 hikes together. It may have to be diluted further, giving back some of the MoF's hoped-for revenue boost from hosting the Rugby World Cup and Olympics/Paralympics. Either way, a primary surplus by FY20 (year to March 2021) looks out of reach, even if the fillip from hosting these outlasts that from co-hosting the 2002 soccer World Cup.

Encouragingly this time, land prices (which are critical for balance sheets and collateral) are stabilising – having fallen for most of the past 25 years. Falling land prices was the common link when the MoF raised the sales tax in both 1997 and 2014. Each time, they had to back-track as consumption and inflation slumped. So, expect minimal, if any, unwinding of QE. The latest form is the BoJ's targeting since April 2016 of a near-zero yield on 10-year JGBs. The aim is to keep yield curves steep and debt-costs down – critical for an economy with the developed world's highest government liabilities-to-GDP, at 230% (OECD data).

Yet, this precludes the BoJ from switching off, or, without sustained inflation, cutting its QE. At ¥80trn per annum (\$730bn) in asset purchases, the vast bulk being JGBs, it's been mopping them up at twice the pace of net supply. Depending on where global yields go, this ¥80trn may vary depending on how much is needed to meet the low yield target. So, any fall should not be seen as 'normalisation'. For BoJ Governor Kuroda, there is no QE "reversal" until a +2%yoy CPI (latest +0.9%yoy) is the norm – that is, driven by demand, not taxes. Under him, the BoJ has doubled its share of JGBs outstanding to 50% (chart 6), leaving institutions chasing riskier assets and/or looking overseas for bonds. This helps cap the yen's 'safe-haven' status. So, the MoF will again hope that, by keeping nominal growth above the average long-term interest rate, it can borrow without raising the debt ratio. This leads some officials to believe the BoJ will be the last to ever stop QE.

So, it's again disappointing that spring's wage-round (shunto) failed to deliver anything perkier than the 2% average one-off rises of 2014-18. Our Phillips Curve analysis suggests sustained wage growth in Japan probably would knock on to the CPI, given the past eight years' unemployment falls (chart 7). BoJ research concurs by identifying a negatively sloped curve, and greater long-term wage responsiveness than in the US. Yet, based on Japan's 1997 and 2014 tax rises, 2019's may be no different in terms of breaking its deflationary psychology.

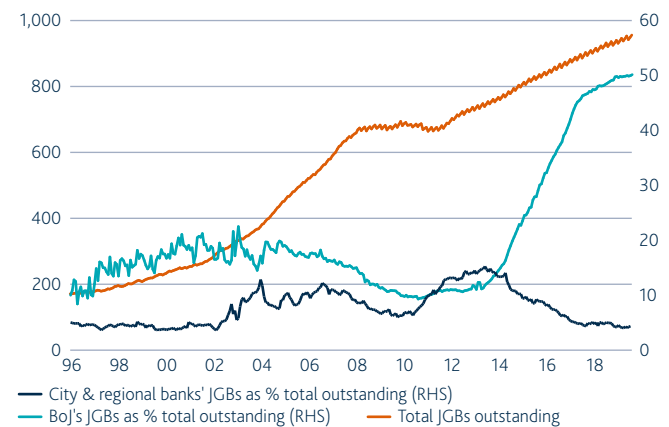
Economic & interest rate projections (p)

% yoy unless stated	'14	'15	'16	'17	'18	'19p	'20p
Real GDP	0.4	1.3	0.6	1.9	0.8	0.8	0.5
Private consumption	-0.9	-0.2	-0.1	1.1	0.4	0.8	-0.1
Business investment	5.2	3.3	-1.5	3.9	3.9	2.3	1.0
Industrial production	2.1	-1.1	0.2	2.9	1.0	-0.5	1.2
Consumer prices	2.7	0.8	-0.1	0.5	1.0	1.1	1.7
Unemployment rate (%)	3.6	3.4	3.1	2.8	2.4	2.3	2.4
Current account (% GDP)	0.8	3.1	4.0	4.2	3.5	3.4	3.2
Gen budget balance (% GDP, FY)	-5.4	-3.6	-3.4	-3.7	-3.2	-3.5	-3.2
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. The BoJ's escalating ownership of the JGB market

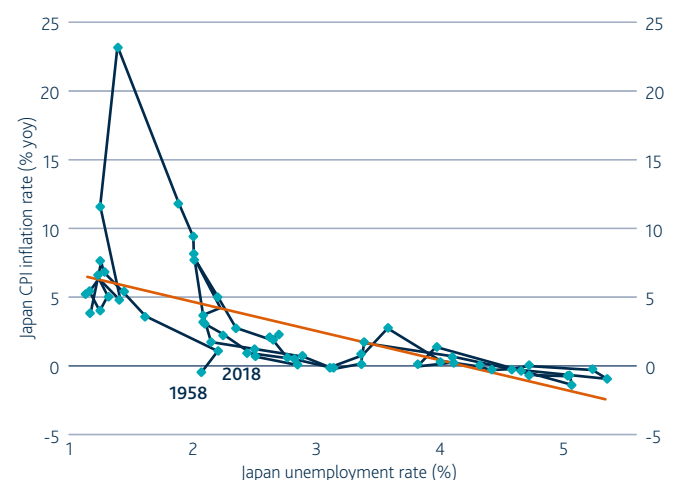
JGBs outstanding in ¥ trillion, & the BoJ and domestic banks' shares as a % of total



Source: Thomson Reuters Datastream, based on BoJ data

Chart 7. Sustained wage increases probably would knock-onto the CPI

Shows fitted trade-off between Japan's unemployment rate (%), & CPI inflation (%yoy)



Source: Thomson Reuters Datastream, based on Ministry of Internal Affairs & Comms data



EUROZONE

With growth having lost momentum (slowing from an average 0.7%qoq in 2017 to 0.3%qoq since), we test whether the macro strains in the periphery are again starting to hold back the core members. To do this, we update our 'Misery Indices' (MIs) to the end of 2020. 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.

Still converging on the strongest?...

Our MIs are also the aggregate of two components: the absolute shift in a country's CPI inflation-rate from its euro-lifetime average, added to its unemployment-rate differential with its cycle (five-year rolling) average. For the full analysis, see our Europe's highly-charged year report (April 2017). Charts 8 and 9 summarise our predictions to 2020. Falling MIs predict falling 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 carried over in 2020. As a bloc, the euro-zone's (weighted) MI in 2020 should, at -1, be the fourth consecutive year of improvement (negative number).

Second, with growth having picked up between 2014 and 2017, it's not surprising to have seen the sharpest improvement amongst members that ran austerity from 2010 in order to cut deficits and debt. Spain, Portugal, Greece, and Cyprus' MIs are now appreciably lower, albeit from a previously high base. For some others, though, unemployment and deflationary pressures from the fiscal squeeze are still dampening improvement in their relative positions. In 2020, Italy's will for the eleventh year running lie in the above-average-misery zone in chart 8. These are much improved on 2010-14, but less healthy than 2018, when the zone's weighted average MI was its lowest since the euro.

Most revealing, however, is what they say about convergence (chart 9). The dip in the zone's weighted average MI from the mid-1990s reflects Germany's recovery after its unification-led recession and the benefits caused 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, a re-widening as policy discipline waned.

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

% yoy unless stated	'14	'15	'16	'17	'18	'19p	'20p
Real GDP	1.5	2.0	1.9	2.5	1.9	1.4	1.2
Private consumption	0.9	1.8	1.9	1.8	1.3	1.3	1.1
Fixed investment	1.7	4.6	4.0	2.9	3.1	2.8	2.3
Industrial production	1.1	2.6	1.6	3.0	1.0	0.5	1.4
Consumer prices (HICP)	0.4	0.0	0.2	1.5	1.8	1.6	2.3
Unemployment rate (%)	11.6	10.9	10.0	9.1	8.2	8.0	7.9
Current account (% GDP)	2.5	2.9	3.2	3.2	3.3	3.2	3.0
Gen budget balance (% GDP)	-2.5	-2.0	-1.6	-1.0	-0.8	-1.1	-1.6
ECB refi' rate (yr-end, %)	0.05	0.05	0.00	0.00	0.00	0.00	0.25

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

Chart 8. The method & sample data behind our Misery Indices (MIs)

The lower the 'Misery Index', the greater the expected economic improvement...

	2019p ¹		Unemployment rates					Misery (p) % point ^{2,3}		
	u rate	CPI	2014	'15	'16	'17	'18	5-yr av.	2019	2020
Cyprus	6.5	1.0	16.1	14.9	13.0	11.1	8.4	12.7	-5	-5
Spain	13.9	1.3	24.4	22.1	19.7	17.2	15.3	19.7	-5	-4
Greece	17.5	0.8	26.5	25.0	23.5	21.5	19.3	23.2	-5	-4
Portugal	6.4	1.0	13.9	12.4	11.1	8.9	7.0	10.7	-3	-3
Ireland	5.3	1.0	11.3	9.4	7.9	6.4	5.6	8.1	-2	-1
Netherlands	3.6	2.3	7.4	6.9	6.0	4.9	3.8	5.8	-2	-1
Belgium	5.6	1.6	8.5	8.5	7.9	7.1	6.0	7.6	-2	-1
Finland	6.8	1.2	8.7	9.4	8.8	8.6	7.4	8.6	-1	-1
Luxembourg	5.3	1.9	6.0	6.5	6.3	5.6	5.4	6.0	-1	-1
Austria	4.8	1.7	5.6	5.7	6.0	5.6	4.8	5.5	-1	-1
Germany	3.2	1.5	5.0	4.6	4.2	3.8	3.4	4.2	-1	0
France	8.8	1.3	10.3	10.4	10.1	9.4	9.1	9.9	0	-1
Italy	10.5	1.0	12.6	11.9	11.7	11.3	10.6	11.6	0	0
Unweighted av.	7.6	1.4							-2	-2
Weighted av. ³	7.7	1.4							-1	-1

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.

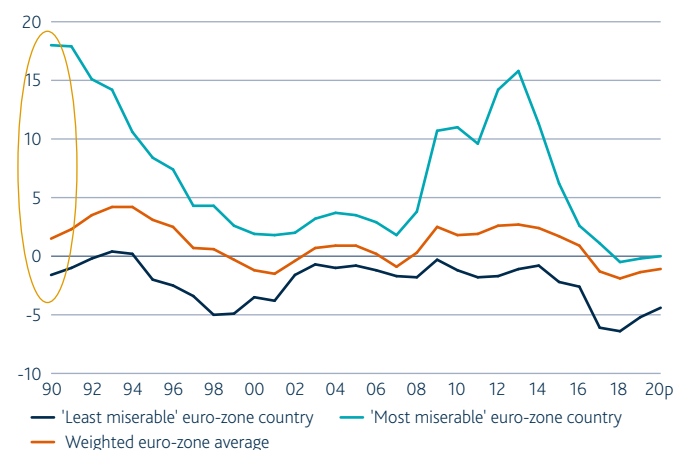
4. Yellow shaded area suggest 'faster than average misery reduction'.

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

Convergence after Maastricht was solid. We proxy it by tracking the highest and lowest MIs each year. Spain currently looks the 'happiest' sizeable economy relative to its recent past (GDP averaging +3.1%yoy since 2015), with Italy relatively the 'least happy' (+1.1%yoy). Greater convergence is shown by the narrowing gap between the two extremes. It suggests 2020 should see the joint largest degree of convergence since the euro, with the periphery leading the charge. This combination of weaker strains in the periphery with slower relative improvement in the core suggests harmful economic divergence during the 2010-'13 funding crisis was reversed. The risk now, though, may be more political than economic. With growth tailing off, MI's off the bottom, and the zone still lacking the degree of economic union that its monetary union demands, the challenge for new leaders will be to avoid political divergence, as populism and reform-fatigue build.

Chart 9. 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

With economics playing 'second fiddle' to politics, there's every incentive to keep policy loose. Since 2012 when the UK recouped its pre-crisis nominal GDP level, 'normalisation' has come fiscally, with the BoE reluctant to raise rates, the pound vulnerable, and (for governor Carney) QT unlikely until Bank rate hits 1.5%. The nuance since 2016's referendum, though, has been Chancellor Hammond's loosening of the fiscal reins, relative to his and his predecessors' (Osborne and Darling's) plans. A lighter touch could again be sought in the autumn Budget – albeit, with Brexit to be financed, offset in some areas. Political risk is high, and the Budget could yet be delivered by a new administration. If so, they might find it easier to justify bigger fiscal give-aways if seen to be more distanced from the post-referendum slowdown. Yet, with Brexit dues to be negotiated, even they may be wary of showing profligacy early on.

Challenges for the new BoE Governor...

The situation is fluid. Although, under current conditions, it seems unlikely that Parliament will accept a 'no-deal' Brexit – keeping the door open for fresh elections and/or a Brexit process that may take years. Even if there is a deal by 31 October, it would most likely be a precursor to sorting out the various legal/trade systems during a transitional period that could extend beyond 2022. This may involve another advisory referendum. To maintain ties, some form of associate membership (e.g. Norway's) and/or access to the Customs Union (Turkey's) or Single Market (Canada's) is still possible. Canada's took seven years. Each option would have strings attached (labour mobility etc) making it unpalatable to many. Any other bilateral deals (e.g. with the US) cannot be activated until/if Brexit is cleared.

High uncertainty will thus endure. This leaves the BoE putting as much store on tactics as medium-term strategy. We expect it to continue following a slow and soft rate-tightening path in pursuit of the "smooth Brexit" it craves. The risk is that it may have to use what little ammunition it has (75bp of rate cuts, more QE) should Brexit threaten the financial system. Should protectionism spread, its window to hike may even close in 2020, keeping liquidity plentiful.

Either way, with CPI driven more by cost than demand, the MPC should fall short of its 'Goldilocks' Bank rate of 2% in the near term. This equilibrium rate (r^*), defined as that needed to deliver trend-growth and anchor CPI to its +2%yoy target, is hoped later to rise to 2-3%, as better productivity spurs wages and leveraging picks-up. Yet (like Japan), the Holy-Grail remains real-wage growth, which has for the first time since the 1860s been squeezed for a decade (chart 11). MPC members concede that forecast errors have reflected optimism about productivity, and overstating the NAIRU. Their assumption has been that productivity – which has only flatlined since the crisis, delivering the UK's own 'lost decade' – begins to lift, justifying higher wage claims.

However, this is not guaranteed. BoE staff believe it takes four years for higher import prices to be fully passed on to a CPI basket that's about one-third imported. The shortfall – still apparent three years after sterling's dive – is presumably being cushioned in exporters' margins. This, together with still rising labour participation (chart 10) may take time to reverse. This lays down two challenges to Carney's successor next February: of helping to fan demand-inflation (via low rates), while also trying (US-style QT?) to ease the downside of QE – evidenced by asset-price distortions, suppressed saving, and funding strains on many pension schemes.

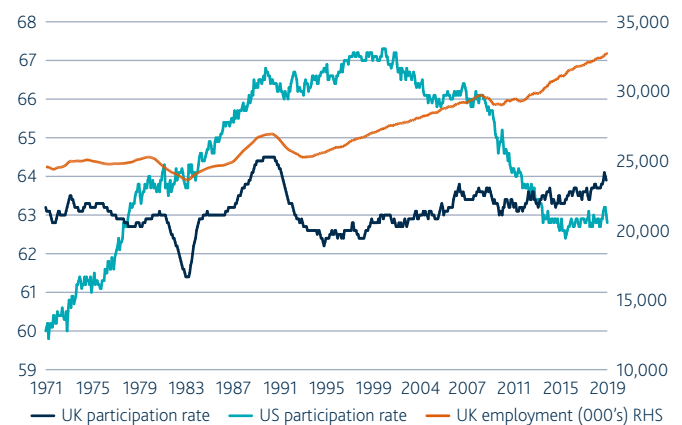
Economic & interest rate projections (p)

% yoy unless stated	'14	'15	'16	'17	'18	'19p	'20p
Real GDP	3.0	2.3	1.8	1.8	1.4	1.2	1.0
Household consumption	2.1	2.7	3.2	2.2	1.8	1.4	1.1
Fixed investment	7.3	3.4	2.3	3.5	0.2	0.6	0.2
Manufacturing production	2.9	0.0	0.3	2.6	0.9	0.3	1.0
Retail prices index	2.4	1.0	1.7	3.6	3.4	2.9	3.3
Consumer prices	1.5	0.0	0.7	2.7	2.5	2.2	2.6
Unemp, ILO rate (3m av, %)	6.3	5.4	4.9	4.4	4.1	4.1	4.3
Current account (% GDP)	-4.9	-4.9	-5.2	-3.3	-3.9	-4.0	-3.8
Gen budget balance (% GDP, FY)	-5.2	-4.1	-2.8	-2.0	-1.1	-1.3	-0.9
BoE Bank rate (yr-end, %)	0.50	0.50	0.25	0.50	0.75	0.75	1.00

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

Chart 10. UK labour-participation grinds up, while the US's falls...

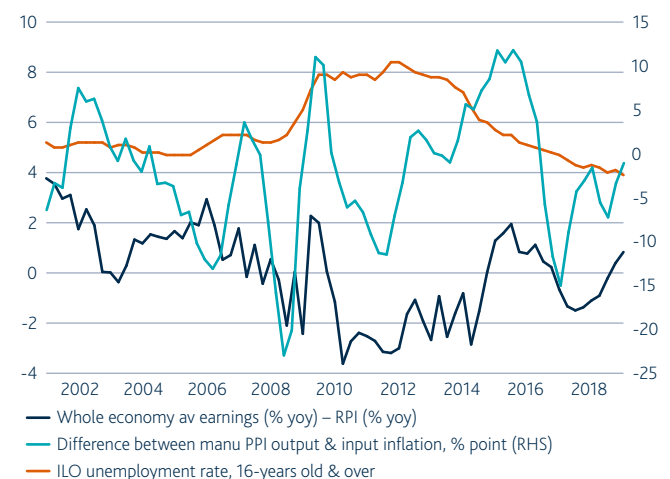
UK/US participation (labour force as % of working age population), vs UK employment, 000's



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

Chart 11. ...Helping to defer UK wage-growth

Unemployment rate (%), vs manufacturers' profit-margins, & real earnings growth (%yoy)



Source: Thomson Reuters Datastream, based on ONS data

 **CHINA**

With activity set to slow further as 2017’s credit tightening feeds through, US tariffs escalate, and China’s trade negotiators try to rebuff concerns about their anti-globalisation policies, growth will remain the priority. Monetary and, especially, fiscal loosening will continue in 2020 – as the authorities tilt further away from the austere, supply-side reforms of 2016 and 2017 to a more pro-demand programme. Ideally, President Xi’s likely tenure beyond the National Congress in 2022 will allow him to address the risks flagged up at the past two annual Central Economic Work Conferences – of limiting asset-price bubbles, taming corporate debt, and managing shadow banking. These will only be prioritised only if protectionism ebbs away.

A disincentive, but it may not be a deterrent...

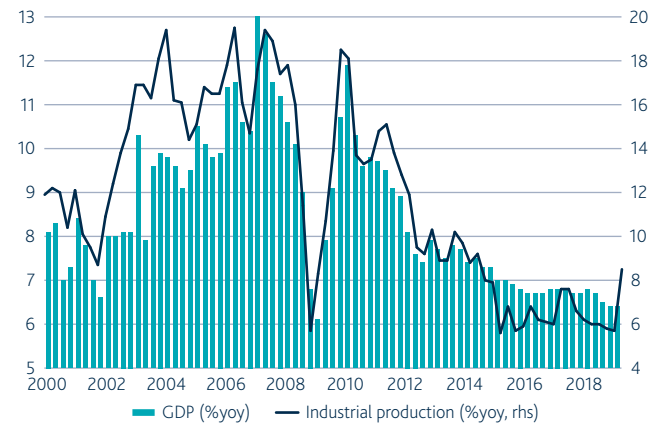
Onus will thus remain on China’s traditional levers for keeping GDP close to target, including agricultural subsidies, and infrastructure. Official signals (e.g. Politburo sessions) should reaffirm China’s growth objectives, with maximising growth around the 6½%yoy needed to double 2010’s GDP level and per capita income by 2020. These have been the core aims since 2015. Inflation (latest 2.5%yoy) may push up further on higher, swine-fever affected pork prices (+14.4%yoy), but a +3%yoy headline CPI should remain only a “predictive target”. Fiscal policy may also be loosened further by “cutting business taxes”.

With growth since averaging 6.7%yoy (chart 12), there’s room later to re-tighten, as PBoC addresses the risks and maintains the renminbi’s quasi-peg against the USD. But, during trade tensions, this seems unlikely. The impulse from allowing money rates last year to fall over 200bp has been reinforced by taking 350bp off banks’ reserve requirements ratios. Last year’s ratio-cuts looked to be obvious ‘sweeteners’ into (June and November’s) US trade talks, as does this May’s cut. But, they also aid SMEs facing an upturn in real borrowing rates (chart 13).

Other monetary tools will be more constrained. The PBoC will be reluctant to let its main policy rates (thus far unchanged) follow money rates down as fast, given that leveraging/debt is still high, and the mixed effect of softening the renminbi. The concern is to avoid another haemorrhaging (\$1trn between 2014 and 2017) of forex reserves and control the currency, as individuals eat into their \$50,000 per annum outflow limit. The RMB has been allowed to fall fastest during global influence, such as Brexit fears in Q2 2016, and higher, Trump-inspired US inflation expectations in Q4 2016. This, plus growing protectionism as China’s bilateral surplus with the US builds, (chart 14) suggests further RMB downside., especially after last December’s already-extended US/China ‘tariff ceasefire’ lifts. Past experience questions whether China will meet the US’s industrial, IP and technology conditions. This raises the chance of adding to May’s steeper tariffs (to 25% from 10% on \$200bn on already-affected exports) with new, 25% levies on another \$300-325bn.

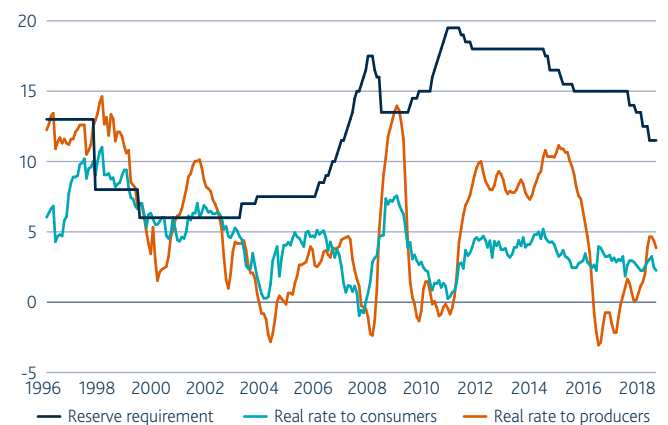
Critically, retaliation may increasingly be sought by inter alia a renminbi devaluation that claws back some competitiveness. But, this risks imploding China’s corporate/banks’ balance sheets exposed to USD debt. In which case, the PBoC may stem the fall by delving into its \$3.1trn reserves – questioning China’s commitment to buying US Treasuries (8% of total, and 17% of international holdings). However, while a reassuring disincentive for markets, this may not prove to be a mutual deterrent.

Chart 12. China has additional levers to keep growth around target...
GDP & industrial production growth (both %yoy); end-quarter data



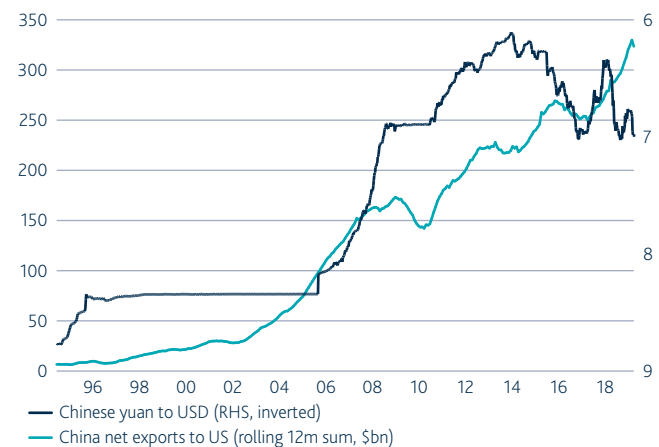
Source: National Bureau of Statistics

Chart 13. ...And there’s more justification now for monetary loosening...
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 14. ...But, PBoC would only reluctantly weaken the renminbi
China/US bilateral trade surplus, 12m total, \$bn. USD/CNY on an inverted axis



Source: Thomson Reuters Datastream

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Contact information

Hermes Investment Management

Neil Williams, Senior Economic Adviser +44 (0) 20 7680 2398 neil.williams@hermes-investment.com

Silvia Dall'Angelo, Senior Economist +44 (0) 20 7680 8049 silvia.dall'angelo@hermes-investment.com

For more information, visit www.hermes-investment.com or connect with us on social media:   

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