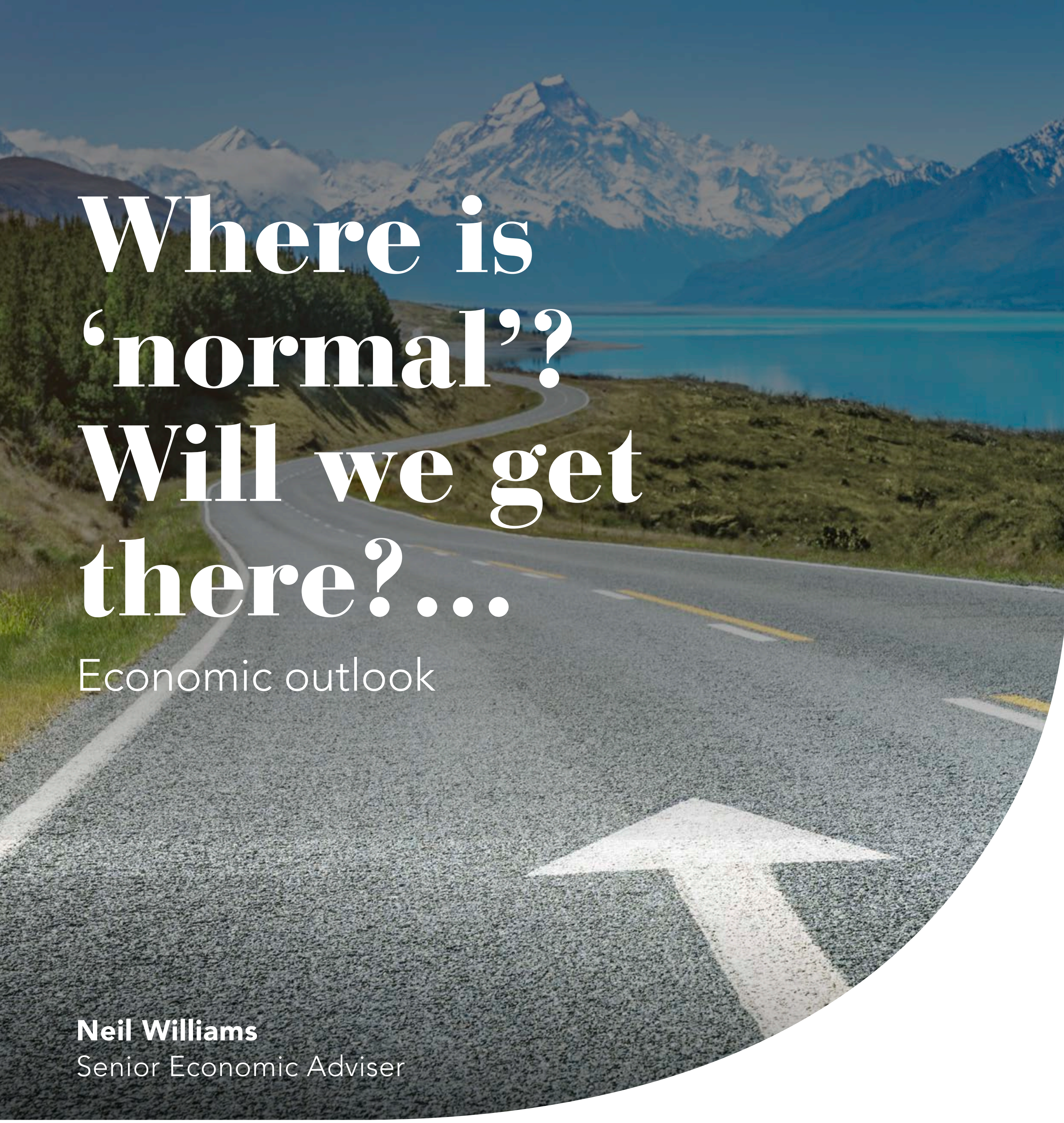

Where is ‘normal’? Will we get there?...

Economic outlook

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Federated Hermes International

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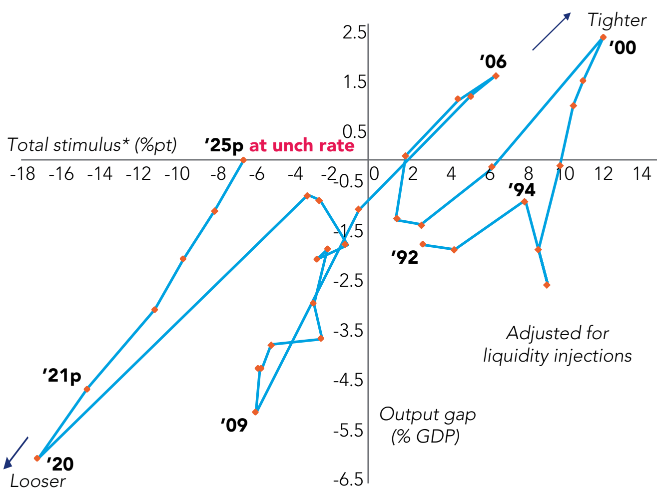
Main points

- By debating the size of their balance sheets, central banks are showing for only the second time since 2008 that they may be worrying about our addiction to QE. QE can be credited with unblocking the system in 2009 and keeping it oiled in 2020. But, by prolonging distortions and widening disparities, it looks too-imperfect-a tool to sustain.
- The road to 'policy normal' as gauged by historical standards is likely to be cut off. The frustration for central banks remains that recoveries since 2009 have been largely output driven with insufficient *demand* inflation to trigger their usual reaction-functions. Maintaining the reflation trade will be predicated to a large extent on further job gains and/or stimulus, especially fiscally. But, with recoveries on track, the opposite looks more likely.
- Yet, for central banks and governments, craving demand-inflation may be easier than sustaining it. Catch-up and base-effect should keep price indices bloated in the near term, and inflation via mark-ups looks more realistic than from QE and wage-growth. But, it remains to be seen how lasting this can be, and the extent to which consumers 'carry the can' as firms adjust for zero-emissions needs.
- We take our 'Policy Looseness Analysis' to the next level, to gauge: how far from historical norms true US and UK peak rates will lie; how appropriate for recovery their overall policy positions (monetary and fiscal) will be; and how much extra stimulus withdrawal may, in principle, be needed from pulling on the other monetary lever, QT.
- In the US, meeting the fiscal plans and the Fed's preferred rate-path would require as much as $3.4trn of QT to get back to policy neutral by 2025, when output gaps are expected to close. This is equivalent to running down 44% of its balance sheet. The inferred run-rate would be two-and-a-half times that in 2017-19, when the Fed's (only) $755bn *total* QT proved too destabilising to continue.
- Similarly, for the UK, implementing chancellor Sunak's fiscal correction, while moving Bank rate slowly back to a 1.5% peak, would require almost £590bn of QT based on the BoE's own metrics. This would mean drilling away as much as 66% of the Bank's balance sheet, at a time when government debt still needs a guaranteed sponsor.
- Such a large down-sizing of balance sheets when the fiscal screw is being tightened and gradual rate hikes loom seems unlikely economically, and foolish politically, given elections in 2024. Yet, for markets, a triple whammy of tightening, against a backdrop of cost inflation, social disparities, and creeping protectionism, may increasingly question reflation trades as stimulus euphoria fades.
- A trade-off will be that policy rates peak-out lower than many expect, as central banks nudge on QT. And, this tightening 'by doing nothing' may remove some of QE's distortions, allowing assets to be priced more on fundamentals than central bank actions. But, either way, when we do set down the road to 'normal', there are compelling reasons why we will not end up reaching it.

Chart 1. US – quantifying the options for getting back to 'policy neutral'…

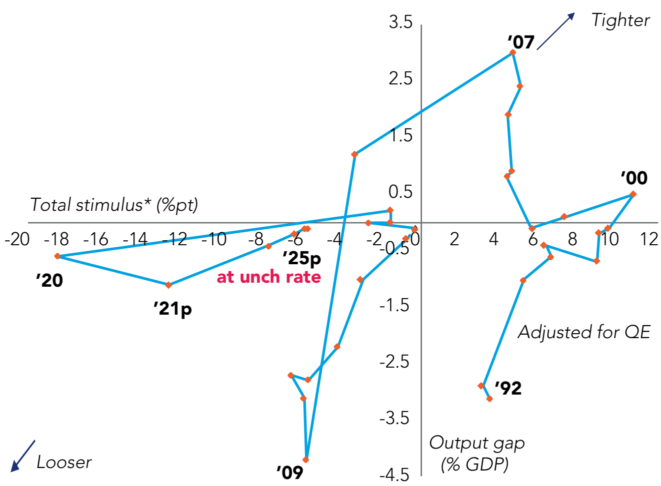
*{(QE/QT adj real rate – its long term avg) + (cyc adj fiscal bal as % GDP – its long-term avg)}



Source: Federated Hermes, based on FRB, BLS, OECD, & Bloomberg data

Chart 2. UK – quantifying the options for getting back to 'policy neutral'…

*{(QE/QT adj real rate – its long term avg) + (cyc adj fiscal bal as % GDP – its long-term avg)}



Source: Federated Hermes, based on BoE, ONS, OBR, & Bloomberg data

By debating the size of their balance sheets, central banks are tentatively showing the first sign since Covid-19 (and only the second time since the 2008-09 crisis) that they may be worrying about excessively loose policy, and our growing addiction to QE. As a result of their purchases since 2008, the world's big four central banks' balance sheets are now totalling $25trn. This liquidity injection to the private sector is equivalent to about 95% of US GDP, or one-and-a-quarter times China's. And it means about three quarters of the world's $40trn central bank assets has amassed in just 13 years.

That is, after the US's last financial (rather than virus-induced) recession ended in mid-2009. QE can be credited with unblocking the system in 2009 and keeping it oiled in 2020. But, by prolonging distortions and widening disparities, it looks too-imperfect-a tool to sustain.

Recovery, but not as we know it…

Encouragingly, the US and UK have now claimed back all, and over one half, respectively of their *nominal* GDP lost since 2019 (chart 3). A similar bounce is seen in household consumption, which, at 60-70% of GDP for major economies, will determine the speed and durability of recoveries. But, with lockdowns slow to phase out, vaccines facing mutant strains, and, once support lifts, households and corporates potentially tending as much to balance-sheet repair as re-leveraging and spending, it may be another two-three years before most economies can sustain their pre-Covid trajectories.

The background frustration for central banks is shown in chart 4, which breaks down these nominal GDP recoveries into their real output and inflation components. Recoveries since 2009 have been largely output driven. And, with output gaps slow to close and wage growth capped by low productivity, margin pressure, and for the most part rising labour participation rates, they've yet to generate enough inflation to trigger their usual reaction-functions.

As a result, even as central banks start to 'muscle flex', the road to 'policy normal' as gauged by historical standards is likely to be cut off. We expect another two years of negative real rates in the US, Japan, UK, and euro-zone. For the UK, this is on top of the 12 we've had. The US, where stimulus has been longest and deepest, and (state-led) lockdowns less severe, will again lead, leaving the Fed as test case for how to push both monetary levers: rate hikes and balance-sheet correction (QT). Its attempt to run QT in 2017 was abandoned after just two years, as its 'tapering' (reinvesting gradually fewer bonds) proved too destabilising. This was at a time when policy rates were also lifting, albeit (nine times between 2015 and 2019) slowly for a typical cycle.

The main economy that has delivered inflation is the UK. But, this looks more a symptom of the pound's net 23% trade-weighted fall since 2007. Only Italy's GDP/CPI trade-off has been worse. Yet, the BoE looks loathe to raise rates till recovery is entrenched and Brexit-effects revealed. And it remains shy of, and is less experienced in, QT. So, the initial policy correction here could come from the fiscal side.

A release of higher precautionary saving would help. The BoE is watchful of the leap in the saving ratio (personal savings to disposable income), from under 7% in 2019 to over 16% in 2020. Yet, with their forecast model assuming the bulk of this higher net worth (mainly bank deposits) is held by those with lower marginal propensities to spend (middle and higher-income earners, pensioners), they're not convinced that unleashing it would spark overheating. And, following March's Budget warning that personal tax thresholds, for example, will be frozen from 2021/22 till 2025/26, any reluctance to scale-back on saving may have increased.

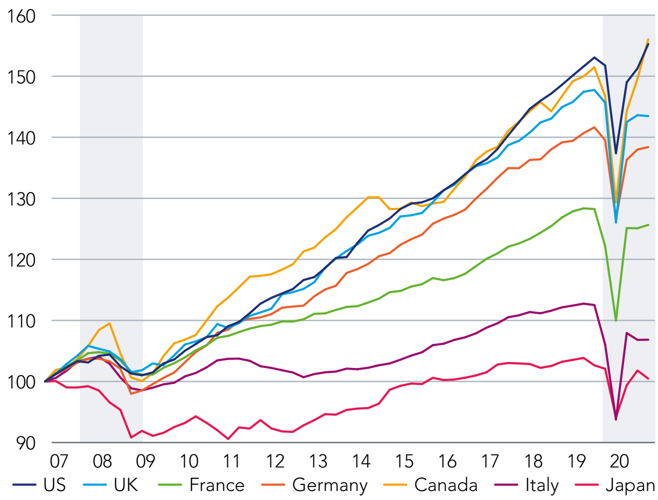
While, in the euro-zone, the ECB was up until Covid declaring *"deflation risks have definitely gone away"*, but that we need to be *"patient on inflation"* (president Draghi, June 2017). Markets were bracing for a new, tightening era, even though, in reality, the ECB by reinvesting coupons was keeping its 'sink' full. This was just as well, given reform-fatigue in Italy, Spain and Greece, Covid, and delay now to dispersing the €750bn Recovery Fund. And, it's in the euro-zone where the growth-risk from QT is probably most acute, with two-thirds of private borrowing long-rate driven. This is the mirror image to the UK, and approached only by the US where mortgages price off long-yield shifts.

Japan may never kick the QE 'drug'. Its reliance spanning 23 years, without convincing inflation, precludes QE from being switched off. And while its purchases have cooled (as falling yields made it easier to hit the near 0% target on the 10-year JGB), this still leaves the BoJ buying bonds at around twice the pace of net new supply. It's already holding 55% of the world's largest government bond market. A fillip from attended summer Olympics and Paralympics would've helped, but was always unlikely to break the engrained deflationary psychology.

As a result, consensus is probably right to expect a neat, 'V-shape' (*real* GDP) recovery in the US. But, for the UK, initial hopes in April 2020 of a 'V' have rightly morphed into something closer to a 'W' or even more divisive 'K'. The same is true for Japan and the euro-zone. China may be the most notable other exception. But, its state-led GDP bounce could yet be eroded by beggar-thy-neighbour policies, especially if the international 'blame-game' intensifies.

Chart 3. Major economies are recouping their nominal GDP…

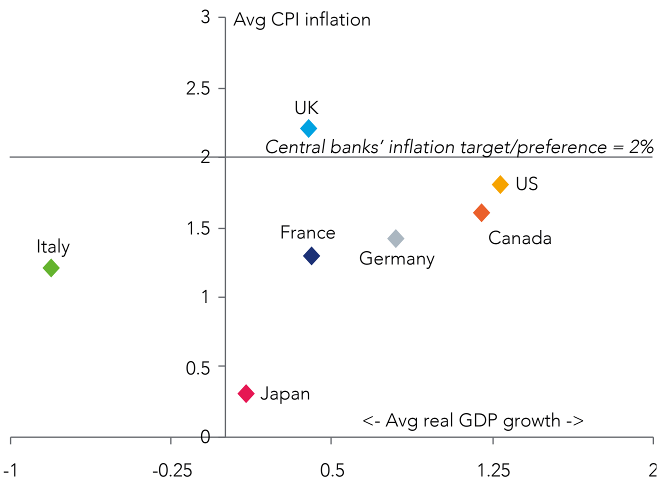
Nominal GDP levels re-based to Q1 2007 (=100). Grey denotes US recession



Source: Refinitiv Datastream, based on national data

Chart 4. But, these output recoveries are still not generating enough inflation

Real GDP growth & CPI inflation rates since 2007. Period averages, both %yoy



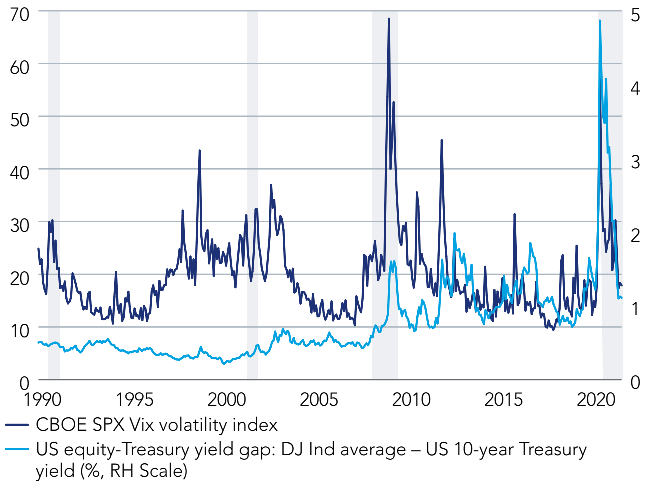
Source: Federated Hermes, based on national data

Markets need stimulus to stay on…

Charts 5 and 6 remind us how important global stimulus has been to risk assets and recovery. The damage to equities in early 2020, prior to fiscal packages, was both outright, and relative to 'safer' government bonds (chart 5). This relative hit dwarfed that of 2008-'09, presumably reflecting the clamp on bond prices that a decade of QE has since established. But, equities' relative recovery since Q2 2020 and lower expected volatility have been impressive, returning the equity-bond 'yield gap' to its pre-Covid level. On a forward-earnings basis, it's even been close to 2007 levels. Much of this must be owed to further monetary expansion and, especially, successive fiscal packages.

Chart 5. Elevated equity markets have powered back...

US equity-bond yield gap (using DJ Industrials & 10-year Treasury), vs VIX volatility index. Grey is US recession



Source: Refinitiv Datastream

In our analysis, comparison of the US Fed's balance sheet and the S&P 500 since QE's start in 2008 Q4 yields a simple correlation as high as 0.88. The relationship is strongest with a 10-week lead, suggesting the S&P on average pre-empts QE changes by two-three months. (See our *Economic recovery – as strong as an ox?* report, April 2021.) Symmetry for QT would surely suggest a similar pre-emption in the opposite direction. On this basis, whittling away the balance sheet via tapering – which the US Fed is hinting at for early 2022 – would remove an important prop to equity markets.

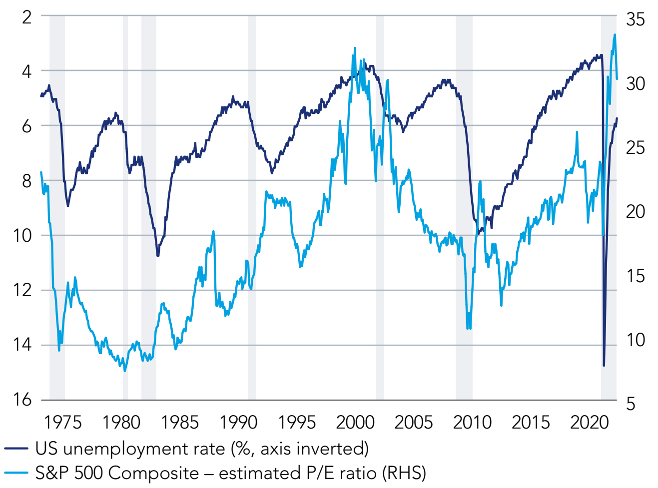
But, more potent could be fiscal correction, already flagged in the US and UK (see below). A noticeable difference in 2020-'21 is the strongly positive contribution of stimulus to growth assets: it was negative in 2008-'09. This surely reflects 2020's 'belt and braces' approach, as fiscal packages this time augmented monetary stimulation.

For policy, the 'proof of the pudding' will be the extent to which stimulus *withdrawal* impedes the real economy. Taking the US unemployment rate as a long-term proxy for global activity, our analysis since 1964 throws up a simple correlation with the S&P 500 of just -0.23, revealing a nine-month lead. Restricting this, though, to the QE-period since 2008 Q4 renders a stronger, -0.83, with the same lead. To make sure, chart 6 maps the unemployment rate, but with the S&P's estimated price-equity (p/e) ratio, which exhibits far more long-term fluctuation than the equity index itself. This similarly offers rising correlations of -0.55 and -0.63 respectively, for the 1975-2021 and 2008 Q4-2021 periods, with an 11-12-month lead.

And this even with the short-term relationship breaking down in 2020, as US job losses reached eye-watering levels. Despite these, the ability of the S&P and p/e ratio to scale new highs during a recession suggests, prior to vaccines, that record stimulus was sufficient to reassure markets that recession and job losses would prove temporary.

Chart 6. But, risk assets are pre-empting further macro improvement

Estimated p/e ratio for S&P 500 Composite (RHS), vs US unemployment rate (inverted axis). Grey is US recession



Source: Refinitiv Datastream, based on BLS data

These observations suggest: *(i)* the importance to risk assets of employment as a demand-indicator has risen over time, presumably as labour markets became less regulated; *(ii)* these assets typically pre-empt changes in QE by up to three months, and in employment by a year; and *(iii)* given hopes of a swift V-shaped recovery, in the US at least, maintaining the reflation trade will be predicated to a large extent on further job gains or, failing those, more stimulus, especially from the fiscal side.

But, with recoveries on track, albeit at different speeds, the opposite now looks more likely. Policy-makers are starting to talk about correction, and labour market scarring should become visible as the tide of liquidity/stimulus goes out. Given their time-leads, this suggests the approach of tapering, less accommodative fiscal positions, and realisation that the best of the employment gains has been seen could, thus, in the absence of new offsetting measures, test growth assets into the autumn.

Where will the inflation come from?...

Yet, for central banks and governments, craving demand-inflation may be easier than sustaining it. Admittedly, base effect and an unleashing of pent-up demand that outstrips the pace of supply-chain repair should in the coming months continue to lift inflation measures. This may be strongest for items whose prices were depressed, but over-represented, during lockdowns relative to their CPI weights (*e.g.* foreign holidays, restaurant meals), and, via base-effect, for countries (*e.g.* US, Japan) whose currencies appreciated most a year ago.

Inflation expectations have understandably revived (US 2-year break-evens through 2.5% this year, UK break-evens above 3%) as lockdowns lift. But, with employment likely to run behind output and labour markets deregulated, central banks should be able to look through this – seeing the longer-term *disinflationary* forces from balance-sheet repair, demographics, and automation. This is a long way from early/mid 1970s Britain, for example, where high public ownership and wage-price spirals contributed to a three-quarters fall in the FT 30 Index between 1972 and 1975. And, in a high-debt world, the alternative now – Japan deflation – is unthinkable for central banks and governments.

First, QE may be part of the problem, not the solution. If it continues to boost asset prices over wages, this could further widen wealth disparities. In reflation terms, it's no good throwing money out of a 'helicopter' if no-one spends it. In practice, the velocity of circulation has been slow to recover (chart 7), given the apparent preference in a liquidity trap for drawing down debt and saving over consumption. QE could thus be accused of getting to those (asset holders) who probably needed it least.

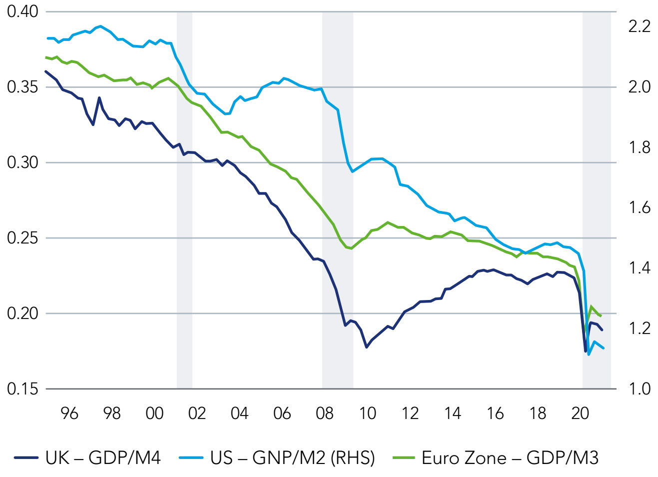
Second, as in 2007-09, rapid employment downturns do not guarantee the sharpest recoveries. Thankfully, US jobs are now springing back, driven by returning workers. If US jobs continue to be clawed back at March-May's run-rate (three-month average) of +541,000, the 7.6 million workers displaced by Covid-19 could, in theory, be returned by November 2022's mid-term elections.

But, with participation stalling, the 'underemployment rate' (U6), which includes those not searching but wanting to work/work more, at 10.2% versus 7.0% pre-Covid, may be slower to fall. And it remains to be seen: *(i)* why permanent lay-offs (close to a seven-year high) are out-running temporary ones by about two-to-one; and *(ii)* how spendthrift returning 'furloughers' can be.

In the UK, the unemployment rate, having risen during Covid from 4.0% to 4.7% (April), has been cushioned. Measured differently to the US, this stands to rise when furloughing lifts, reinforcing BoE governor, Bailey's warning that *"The labour data at the moment are the hardest to interpret"* (4 February). It offers little hope that UK real-wage growth – having been stagnant for the first decade since the 1860s – can sustain its recent base-assisted gains, keeping the Phillips curve flat (chart 8).

Chart 7. Velocity of money – pouring doubt on QE's transmission mechanism

Ratio of nominal GDP to broad money. Grey is US recession



Source: Refinitiv Datastream, based on FRB, BEA, ECB, Eurostat, BoE, & ONS data

Chart 8. Helping to keep Phillips Curves relatively flat

Shows UK's fitted trade-off between its unemployment rate (%), & RPI inflation (%yoy)

Source: Refinitiv Datastream, based on ONS data

Third, even if green shoots show in next spring's cluster of pay claims (*e.g.* IG Metall, Japan's *shunto*), they may be trampled underfoot unless corporate pricing-power builds. Our analysis using implicit-price indices from GDP data suggests that, while still subdued, US corporates' (non-banks) pricing-power is now reviving: at +1.6%yoy, its perkiest since Q4 2019. Recent improvements elsewhere in economy-wide inflation, though, reflect costs (Japan's tax hikes, sterling's depreciation, and a statistical quirk in measuring the UK's public-sector deflator), more than demand.

Admittedly, this inflation source, via price mark-ups, looks more realistic than through the lagged effects of QE and wage-growth. Especially as pent-up demand for relatively price-inelastic products and quasi-monopolies translates into margin repair. But, it remains to be seen how lasting this can be in a competitive world, and the extent to which consumers will carry the can as companies adjust costs for zero-emissions requirements.

Fourth, should political distrust and beggar-thy-neighbour policies build as we suspect, the cost-led, inflationary flame from stagflation would surely snuff itself out. The risk of slower international trade still appears outside most official projections. Implicit to the IMF's April analysis, for example, is an average 7.5%yoy volume increase in 2021 and 2022 (upgraded from +7.2% in January's forecast) after -9.6% in 2020, across advanced economies (about +7.0%yoy) and emerging markets (+8.0%yoy).

Admittedly, we do seem to have a less confrontational US President. For markets, trade frictions may thus (like Brexit) be more a 'crack-in-the-ice', than a 'cliff-edge', event, with a disparity, at least initially, between goods and service sectors, and broadening out to countries whose 'cheaper' imports can fill the gap. This potentially offers a reversal of the goods-services rotation under Covid.

If so, direct vulnerability lies not with the US (whose trade dependence is limited) and China (where dependence is falling), but smaller, open economies. These include South East Asia (Malaysia and Thailand's trade ratios exceed 100% of GDP, Vietnam's 200%, Singapore's 300%), Australia and New Zealand (46% and 56%), UAE (160%), and core Europe (Germany 88%, UK 64%, Netherlands 150%).

So, where is 'normal'?...

Policy, while less loose, will need to give priority to preserving recovery and generating demand inflation. Central banks increasingly question their traditional reaction-functions (CPI targets, Phillips Curves), yet none of their alternatives (*e.g.* the US Fed's move to average, rather than fixed, inflation targeting) would, meaningfully, tighten monetary conditions. The FOMC from 2009 talked up the efficacy of QE, but has been more muted on the down-side from QT. This suggests their latest 'dot-plot' peak rate of about 2.5% after 2023 may not fully take account of QT.

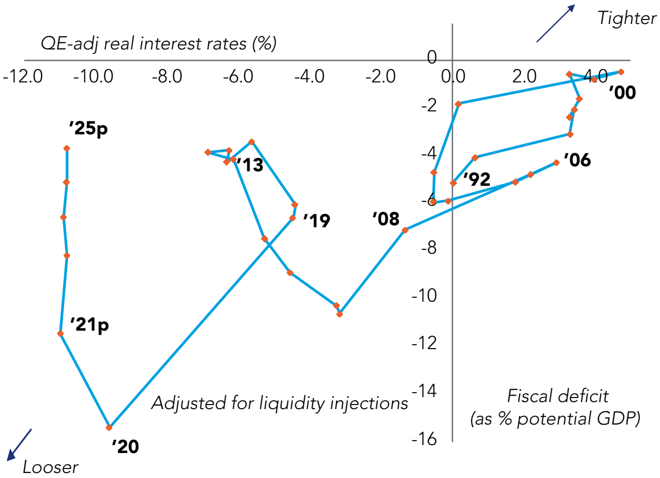
The 'Taylor Rule' currently also pitches the 'appropriate' funds target at 2.25-2.50%, assuming the longer-term NAIRU lies close to the average 4.0% unemployment rate the FOMC expects. Yet, by taking account of QE, QT, the fiscal outlook, and the US Fed's own metrics, our *Policy Looseness Analysis* suggests the US has been running a *true* policy rate as low as -8.0%, or -9.5% in real terms (chart 9). We quantify the impact of US QE by adjusting real rates for former chair Bernanke's assertion that the $600bn part of QE2 in 2011 was akin to slicing an extra 75bp off the funds target. (See our *Tightening by doing nothing* report, May 2017.)

Chart 9 also takes account of president Biden's fiscal plans: to raise $3.6trn first-round, net revenue over a decade, from *inter alia* higher main corporate (from 21% to 28%) and top personal tax rates (from 37% to 39.6%). On a conservative basis, we defer these in chart 9 to *after* the 2022 mid-terms and average them out, starting as an annual net fiscal correction of about 1.5% point of GDP. This, over its term, would effectively take back last year's fiscal stimulus. On the basis first of all of unchanged monetary policy, the extent of the fiscal correction is shown.

Similarly, the UK's policy-map is shown in chart 10, using the BoE staff's simulation in 2009 that £200bn of QE would potentially be equivalent to taking 150bp off Bank rate. Together with record fiscal packages, this confirms by far the loosest overall stance in nearly three decades of data, probably post-War, and points to even lower real rates in 2022 (-6.5% nominal, -9.0% real) as inflation rises temporarily. This questions the need, should the debate reappear, to follow the ECB and BoJ onto negative 'headline' rates.

Chart 9. The US's expected monetary & fiscal policy map to 2025

Using QE-adjusted Fed funds target, Fed's core PCE projections, & cyc-adj fiscal balance as % GDP. Projections also based on latest funds target & QE

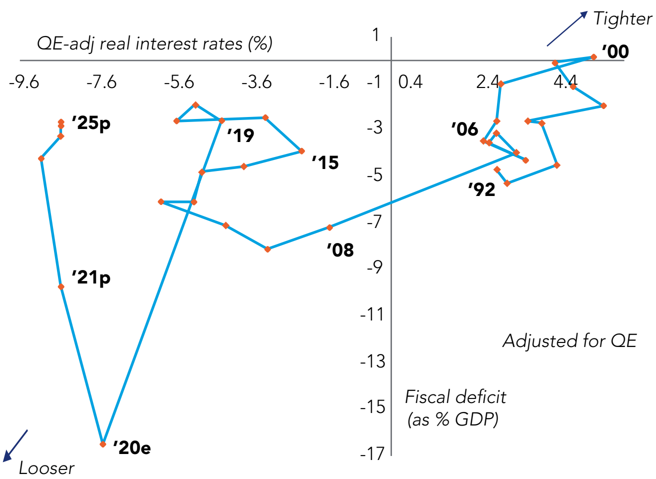


Source: Federated Hermes, based on FRB, BLS, OECD, & Bloomberg data

Implicit to chart 10 is the consensus expectation that any meaningful policy correction in 2021 and 2022 will come from the fiscal side. Chancellor Sunak set out the bones of this in his Budget, with measures to address the deficit (*e.g.* frozen personal tax thresholds, higher corporation rate) loaded for after 2021/22. Yet, with GDP below trend, any further measures may have to be subtle (*e.g.* massaging down public expenditure relative to current plans) or more back-end loaded, rather than via early, widespread tax hikes. One palliative might be to tailor future fiscal withdrawals (or stimuli) to environmental performance. (See our *Building back better: why climate action is key to a resilient recovery* report, May 2020.)

Chart 10. The UK's expected monetary & fiscal policy map to 2025

Using QE-adjusted Bank rate, BoE's CPI projections, & cyc-adj fiscal balance as % GDP. Projections also based on latest Bank rate & QE



Source: Federated Hermes, based on BoE, ONS, OBR, & Bloomberg data

But, while helpful in quantifying the looseness of policy, this tells us little of how *appropriate* these policy positions will be as economic recoveries evolve? Charts 1 and 2 thus go a step further, to get a handle on where 'policy neutrality' lies, and how far from it we'll end up. Using the US and UK government's targeted fiscal correction to 2025 and the Fed/BoE's own trade-offs, we gauge: *(i)* how far from historical norms their true-peak rates will lie; *(ii)* how appropriate for the recovery these positions will be ('neutral' for the economy?); and *(iii)* how much extra stimulus-withdrawal may thus been needed from pulling on the other monetary lever, QT.

The charts attempt to map the overall stimulus versus the output gaps estimated respectively by the OECD and OBR. The extent of stimulus is gauged by how far from its long-run average the combined monetary and fiscal position lies, using the same variables and trade-offs as in charts 9 and 10.

Stimulus is plotted as a negative on the axes, and monetary and fiscal impulses are assumed equal potency. The idea being that, as policy 'normalises', the points should corkscrew back to the vertical axis as recovery (closing output gap) warrants stimulus removal.

On this basis, chart 1 for the US suggests: *(i)* incorporating the fiscal plans would need 660bp worth of additional, monetary tightening to concur with output-gap closure ('policy neutrality') by 2025; So, *(ii)* if the US Fed is serious about its current 'dot plot' inferring about +240bp of rate hikes to a funds-target peak after 2023, this still leaves some 420bp worth of extra tightening needed from tapering/QT. Admittedly, a stronger US dollar could facilitate some, though not all, of this.

But *(iii)* using the Fed's own metrics, this would require as much as \$3.4trn of QT, equivalent to running down 44% of its balance sheet between 2022 and 2025. This inferred run-rate of \$850bn *per annum* would be two-and-a-half times their QT run-rate in 2017-19, when the Fed's (only) \$755bn *total* QT proved too destabilising to continue. **In reality, the likelihood then is that either the Fed stops short again to preserve growth, or clings blindly to the econometrics and risks knocking the economy 'off its perch'. We suspect the former, a 1994-style risk where the Fed falls 'behind the curve' and stores up problems down the road, more than the latter.**

Similarly, for the UK, chart 2 suggests: *(i)* if chancellor Sunak's threatened fiscal correction for removing slack (closing the output gap) is enacted by 2025, the overall monetary stance would need to tighten by an additional 580bp (distance from the origin) to get policy back to normal. BoE governor Bailey has thus far been less specific than his predecessor about quantifying the preferred peak rate; But *(ii)* using Mr Carney's mantra that there would be no QT till Bank rate was elevated to 1.5%, (currently 0.1%), the inferred 140bp rate tightening would, on this basis, need 440bp worth of additional tightening via QT. This in turn equates to £587bn of QT using the BoE's own metrics; and *(iii)* this would mean drilling away as much as 66% of the Bank's £895bn balance sheet, at a time when government debt still needs a guaranteed sponsor.

On both counts, the US and UK, such a rapid and large-scale down-sizing of their central banks' balance sheets at a time when the fiscal screw is also being tightened and gradual rate hikes loom seems unlikely economically, and foolish politically, given US and UK elections in 2024. Yet, for markets, while reflation trades have rightly been appropriate, the spectre of a triple whammy of tightening – tapering, fiscal correction, and eventual rate hikes – against a backdrop of cost inflation, social disparities, and creeping protectionism, may increasingly question reflation trades as stimulus euphoria fades.

A positive trade-off, of course, will be that policy rates can peak-out lower than otherwise, as central banks supplement them by nudging the other lever, QT. And, this extra tightening 'by doing nothing' (reinvesting fewer maturing bonds) may begin to remove some of QE's distortions, allowing assets to again be priced more on fundamentals than central bank actions. But, either way, when we do set down the road to 'normal', there are compelling reasons why we will not end up reaching it.

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- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

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