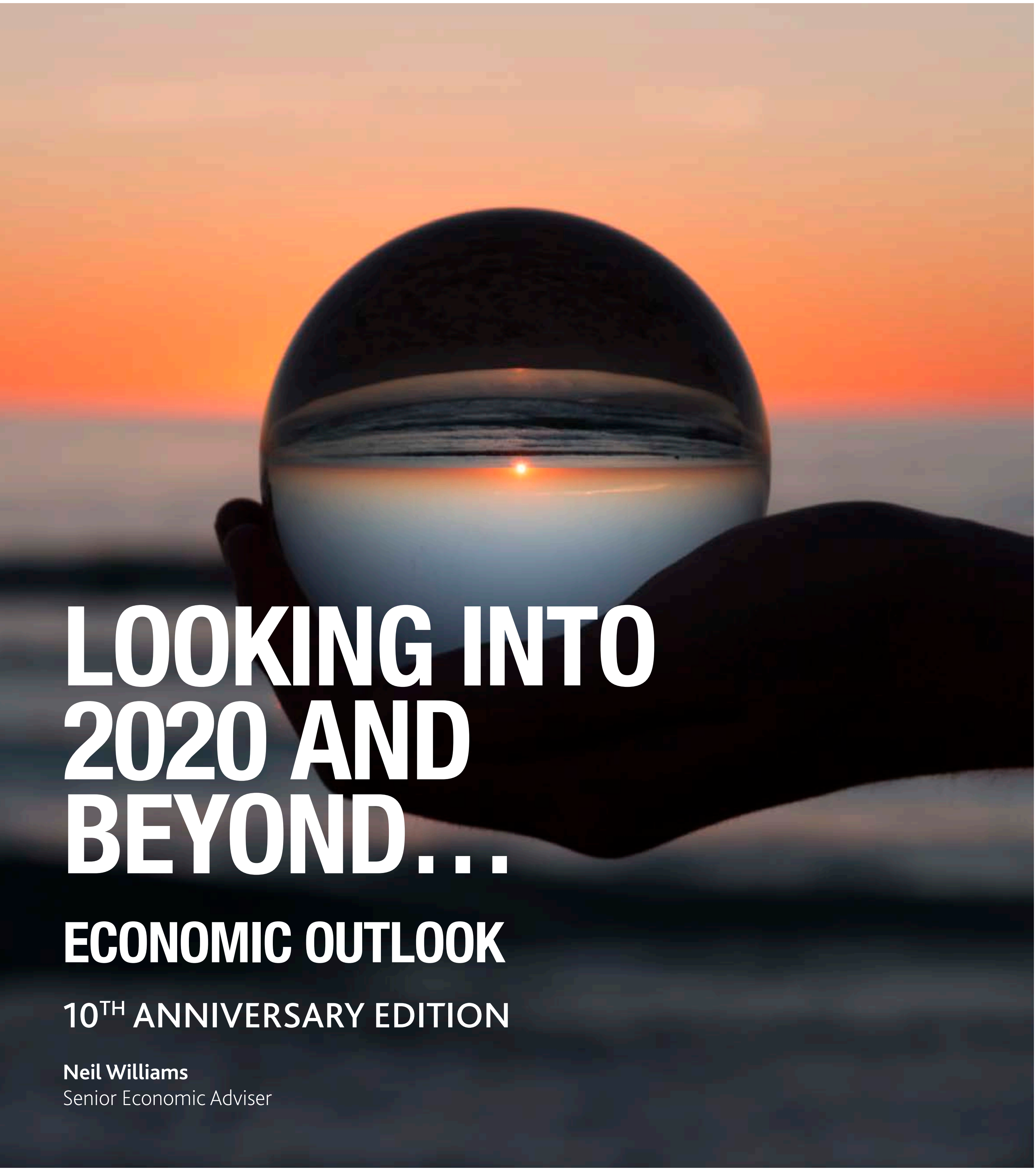

LOOKING INTO 2020 AND BEYOND…

ECONOMIC OUTLOOK

10TH ANNIVERSARY EDITION

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For professional investors only

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HERMES
INVESTMENT MANAGEMENT

MAIN POINTS

- This edition marks the tenth anniversary of our *Economic outlook*. In that time, major economies blighted by the 2008 macro crisis have more than recouped their GDP. But, with households, corporates and governments tending more to balance-sheet repair than to spending, central banks are reverting to the tools that failed them.

- Low rates continue to distort decisions, while QE's boost to asset prices has become counter-productive. In this way, 2020 offers more of the same. Yet, differences could include a step-up in geopolitical risk that's so far not been allowed to disrupt stock markets.

- In which case, the risk to elevated markets comes not from central banks, but political distrust and protectionism. The contradiction of wanting to address imbalances and distortions yet wanting to be alert to increasing trade tensions and voter enmity is the starting point in 2020. But, it looks a convoluted wish-list that cannot please all.

- Amid these conflicting forces, our macro outlook is based on five core beliefs. First, political distrust and beggar-thy-neighbour policies will continue to build. The 1930s revealed few winners from a trade war. Retaliation could include a reluctant China currency-devaluation. This and other factors threaten a deflationary return to the US.

- Second, inflation will reappear but, it will be the 'wrong sort'. Central banks will have to 'turn a blind' eye as economies stagflate. With the cost inflation proving temporary, we may then, in the longer-term, need a sizeable mindset shift as deflationary forces (demographics etc) re-emerge.

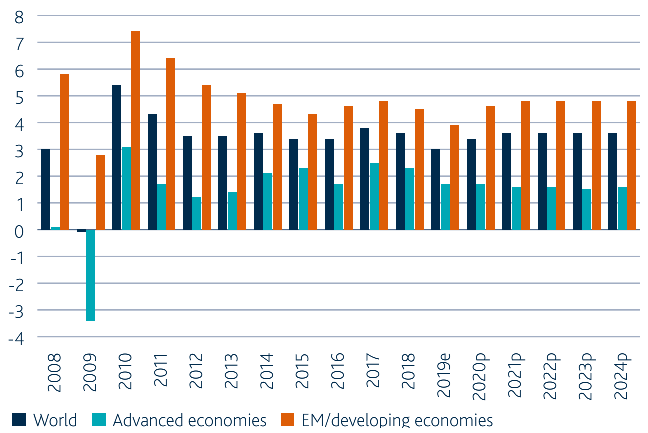
- Third, the road to 'normal' will remain closed off, as central banks fear their shadows. The US Fed, as test-case, has stopped QT after just two years, and is rebuilding its balance sheet! By factoring in QE, the true US funds rate close to -2% will not get anywhere close to its pre-2008 levels.

- Fourth, governments will increasingly offer fiscal solutions to appease voters, and retrieve the 'baton' from central banks. Mr Trump may reflate again; Mr Abe is taking Japan into its third decade of loosening; and the UK is ditching its deficit-ceiling. Even in the euro-zone, deficit-reduction and negative yields should make it easier to permit fiscal expansion.

- And, finally, in emerging markets, the fundamental outlook in a more protectionist/stronger USD scenario may be less rosy. Vulnerability lies with non-commodity exporters with high exposure to short-term USD debt and foreign saving needs, such as Turkey and Argentina. But, for others, external debt-ratios are lower, with fewer currency pegs to have to protect

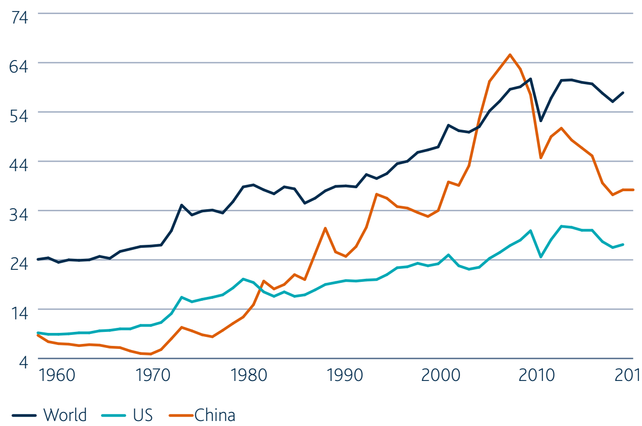
- So, political fragility, protectionism, cost inflation, and dissipating growth suggest renewed volatility. The dilemma for central banks may thus be between using their limited ammunition or letting fiscal expansion do the work. We will probably see a bit of both, rather than an inconclusive tug-of-war that threatens recession. Otherwise, worryingly, in the 'Lunar Year of the Rat', 2020 would risk looking a bit like the last 'Rat Year': the crisis of 2008!...

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



Source: IMF's October 2019 world economic projections

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



Source: World Bank data (*goods & services)

COMMENT

This edition marks the tenth anniversary of our *Economic outlook*. In that time, major economies blighted by the 2008 macro crisis have more than recouped their real GDP. But, with households, corporates and governments all tending more to balance-sheet repair than to re-leveraging and spending, central banks not getting the inflation they crave are reverting to the tools that failed them. Ultra-low rates continue to distort (e.g. saving, employment decisions), while QE's boost to asset prices has become counter-productive – widening disparities, stuttering demand, and stymying inflation. In this respect, 2020 offers more of the same, where, lubricated by a decade of cheap money and a $15trn sink of QE, investors fear missing out on reflation trades, even if they lack conviction. Differences, though, could include a step-up in geopolitical risk (US/China, European populism, Hong Kong) that so far has not been allowed to disrupt most stock markets.

Limited monetary ammunition versus fiscal expansion…

In which case, the risk to elevated markets comes not from central banks scared of their own shadows, but protectionism and distrust. The 1930s revealed few winners from a trade war. Should stagflationary forces build from such a supply-shock, the cost-led inflationary flame will snuff itself out. Helpfully, ultra-cheap borrowing costs offer incentive to governments to open the fiscal box, albeit so far at a staggered pace (expansionary in the US/Japan, lagging in the euro-zone/UK). All this has modern precedent in deflationary Japan. And, while differences exist, even these are not reassuring (see our 'Japanification' report, Q3 2019).

This, plus the contradiction of wanting to address imbalances and distortions yet wanting to be alert to increasing trade tensions and voter enmity is the starting point in 2020. But, it looks a convoluted wish-list that cannot please all. Our economic projections on pages 3-6 are predicated on growth momentum ebbing away in 2020 and 2021, on the maturity of the cycle, and creeping protectionism. The by-products being a reversal of what little monetary 'normalisation' there's been (US real rates are again heading into negative territory), more profligate governments, and yet the shine taken off risk assets underestimating the effects (charts 1-2).

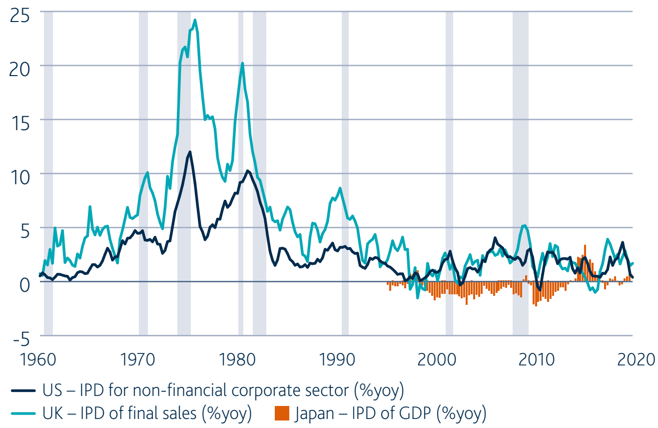
Amid these conflicting forces, our macro outlook is based on five core beliefs. First, political distrust and beggar-thy-neighbour policies will continue to build. US Democrats may oppose a general approach to trade akin to the Smoot-Hawley reforms of 1929-30. This imposed up to 20% tariffs on over 20,000 US imported goods, covering as much as 60% of dutiable imports. It spread like 'bush-fire', with Europe finding new partners and Canada 'retaliating' even before they became US law.

However, the President could still invoke 'Super 301' to impose tariffs without approval on countries deemed to be engaging in "unfair" trade practices. The coverage, thus far, looks somewhere under one-fifth of dutiable imports. Yet, without a softening into the 2020 US Election (page 3), this could build. For markets, protectionism may thus (like Brexit) be more a 'crack-in-the-ice', than a 'cliff-edge', event. Either way, expect a further disparity, at least initially, between goods and service sectors, and a broadening out to countries whose 'cheaper' imports then fill the gap.

Retaliation could include a reluctant China currency-devaluation more aggressive than the 3% fall assumed by forwards for three years' time (page 7). Eyebrows would be then be raised about China's commitment to US Treasuries, potentially raising US mortgage rates (priced on long yields) just as the US deficit is widening. This, and devaluations elsewhere (e.g. S.E. Asia), could generate a deflationary return to the US.

Second, we may initially experience the opposite growth/inflation mix. A slower growth/higher inflation world would also frustrate. Should protectionism build, inflation will reappear. But, it will (like 2011 with oil) be the 'wrong sort': cost-push led by tariffs, goods and labour

Chart 3. But, pricing-power has been modest – even without protectionism
Implicit price-inflation for non-financial corporate sectors (%yoy). Grey denotes US recessions



Source: Refinitiv Datastream, based on national data

shortages, rather than demand-pull. Central banks will have to 'turn a blind' eye as economies stagflate. This portends more to the inflation rises of the early 1980s/1990s recessions, than the overheating of the late 1980s/mid-2000s. With the cost inflation proving temporary, we may then, in the longer-term, need a mindset shift as deflationary forces (demographics etc) re-emerge.

This is especially likely if wage growth fails to keep up. US inflation expectations anchored around pre-QE levels mean the Fed can tolerate faster wage-growth. BoE officials admit overstating the NAIRU. Some green shoots are showing, notably in the US, Germany, and UK, but may be trampled underfoot unless corporate pricing-power builds. Chart 3 suggests recent improvements have reflected cost increases (Japan's tax hikes, GBP depreciation) more than demand. Japan's *shunto* will be critical (page 4).

Third, the road to 'normal' remains closed off. Central banks fear that QT as the corollary of QE would have contributed to an asset-price deflation that throws out the baby (growth) with the bath water. This risk looked most acute in the long-rate sensitive US and euro-zone (page 5). The Fed, as test-case, has stopped QT after just two years, and is *rebuilding* its balance sheet! By factoring in QE, the true US funds rate looks closer to -2%, and is unlikely to get anywhere close to its pre-2008 levels (page 3). With Brexit, the BoE may not reach even the 1.5% Bank rate it wants before QT.

Fourth, governments will increasingly offer fiscal solutions to appease voters, and retrieve the 'baton' from central banks. Mr Trump may reflate again to re-attract centrist voters. Mr Abe is taking Japan into its third decade of loosening, and the UK is ditching its deficit-ceiling (page 6). The ECB can consider positive (nominal) rates only if growing political tensions don't unravel the economic union that monetary union needs (page 5). This is years away, even with new personnel. The good news is a sub 1%-of-GDP deficit and negative yields make it easier for Germany to tolerate a zone-wide fiscal expansion into their own 2020 Election.

Finally, in emerging markets, the outlook in a more protectionist/stronger USD scenario may be less rosy than the IMF expects (chart 1). Vulnerability lies with non-commodity exporters with high exposure to short-term USD debt and foreign saving needs, such as Turkey and Argentina. But, for others, external debt-ratios are lower, with fewer currency pegs to protect.

So, political fragility, protectionism, cost inflation, and dissipating growth suggest renewed volatility. The dilemma for central banks may thus be between using their limited ammunition or letting fiscal expansion do the work. We will probably see a bit of both, rather than an inconclusive tug-of-war that threatens recession. Otherwise, worryingly, in the 'Lunar Year of the Rat', 2020 would risk looking a bit like the last 'Rat Year': the crisis of 2008!

UNITED STATES

While the macro outlook remains constructive – even after 10-years of expansion – the political outlook is difficult, with the impeachment-enquiry of President Trump and November 2020 election offering little chance of bipartisan consensus. An election-year fiscal stimulus is not unprecedented, with a Republican President and Democrat-led House having passed a $152bn (1% of GDP) package in 2008. But, that was near recession. Growth should continue, albeit more slowly, with unemployment straying not far away from its 3.4% 50-year low, and real activity climbing further beyond its pre-crisis peak (now +21%). Yet, with his approval rating historically low and stable (40-44%), re-election will probably need Trump to re-attract centrists, perhaps via infrastructure/ healthcare spending as counterweight to the one-nation policies (protectionism, immigration) that hold his base. Either way, Fed policy will stay ultra-loose relative to maturity of the cycle.

Trump may need to re-attract centrist voters…

Democrats holding the House may push even harder to raise spending programmes, and revamp healthcare and NAFTA. But, despite their rhetoric, they will have little hold over trade policy. Trade tariffs have so far been piecemeal. Although, while limiting Trump's 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 deepen his stance. This has not been used pervasively since the WTO's formation in 1995. Yet, US disaffection with the WTO, retaliation by China, and Trump's need to keep favour into the election offer extra incentives to play this card. Democrats may thus, in practice, have a much weaker hold over trade policy than their rhetoric suggests.

So, with fiscal correction now even more improbable into the election, upheaval will helpfully have been reduced by Congress' raising of the Federal debt ceiling until mid 2021: i.e. after the (new) President gets his/her feet under the table in January 2021. 'Default' here of course is only via inflation, but further disruption would have ensued had it not been raised beyond the $22trn (103% of latest GDP) outstanding (chart 4). This would've affected both sides, with obstructive Democrats also risking their election chances, much in the way that Republicans 'contributed' to Clinton's re-election in 1996.

Meanwhile, the Fed, having issued an "insurance policy" of three rate cuts in just three months, will not want to return swiftly to negative real rates. With US mortgage rates typically priced off the long Bond, the circa 50bp yield-fall during the Fed's unusually abrupt shift, from a tightening to loosening bias (about six months), reinforces the effect. By taking account of QE, QT, and the fiscal outlook, our 'Policy Looseness Analysis' suggests a true funds rate closer to -2%, or -4% in real terms. (See our 'Tightening by doing' nothing report, May 2017.) Using this, chart 5 confirms the Fed should, on its own rate projections, fall easily short of taking the de facto real rate anywhere close to its pre-2008 levels – with Trump's 2017-2019 fiscal expansion offering an extra support to growth.

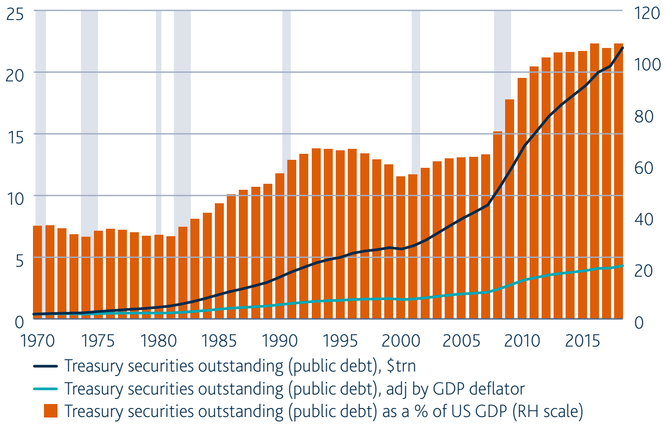
Our analysis incorporates the Fed's increasingly dovish strategy. QT was stopped in August, ending a period of just two years. This involved a near halving of QT in 2019 (from $600bn to $305bn) compared to the initial aim in September 2017 of sustaining it at Q1 2019's pace. On the basis of the Fed's trade-offs, this QT-saving was equivalent to precluding another 25bp rate hike. Further, its intention now to purchase $60bn per month of Treasury bills until at least Q2 2020 is aimed at re-bloating the balance sheet, providing funds, and keeping curves steep. At this pace, two years of QT will have been completely negated by the time of the 2020 election – confirming not just the end, but a reversing of, monetary 'normalisation'!

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

% yoy unless stated	'15	'16	'17	'18	'19e	'20p	'21p
Real GDP	2.9	1.6	2.4	2.9	2.3	1.8	1.4
Personal consumption	3.7	2.7	2.6	3.0	2.3	2.0	1.8
Business investment	1.8	0.7	4.4	6.4	3.0	2.2	1.5
Industrial production	-1.0	-2.0	2.3	4.0	1.2	1.0	0.5
Consumer prices (nsa)	0.1	1.3	2.1	2.4	1.9	2.3	3.0
Unemployment rate (%)	5.3	4.9	4.4	3.9	3.6	3.8	4.0
Current account (% GDP)	-2.2	-2.3	-2.3	-2.4	-2.5	-2.5	-2.6
Fed budget balance (% GDP)	-2.6	-3.1	-3.4	-4.2	-4.6	-5.0	-5.3
Funds target (yr-end, %, upper)	0.50	0.75	1.50	2.50	1.75	1.25	0.75

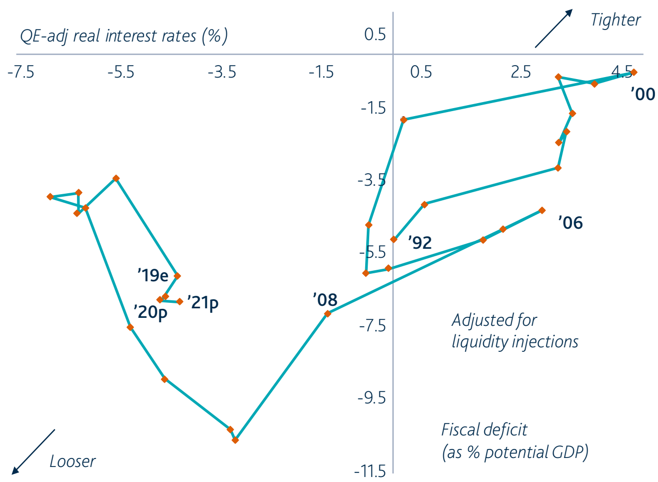
Source: National data, Hermes Investment Management, OECD, & Consensus Economics

Chart 4. US Treasury debt outstanding, in nominal & real terms
US securities outstanding ($trn), & as a % of GDP. Grey blocks denote US recessions



Source: Refinitiv Datastream, based on US Department of the Treasury data

Chart 5. The US is entering its twelfth year of relatively loose policy
Using QE-adjusted funds target, core PCE, & cyc adj fiscal bal. Based on dot-plot medians



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 extend a policy loosening spanning over 20 years. Activity had been building: real GDP rose for nearly two years until the end of CY17 – the third longest stretch since the 1990s' asset-price collapse. Also, 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 stimulants have lost their edge. With personal consumption (55% of GDP) lacklustre into October's sales-tax rise (contrary to its sizeable front-loading into 1997 and 2014's hikes), the yen exposed to safe-haven flows, and trade risks threatening the auto sector, the end of deflation is still not assured.

Breaking the deflationary psychology...

Encouragingly this time, land prices (critical for balance sheets and collateral) are stabilising, having fallen for most of the past 25 years. Falling land prices was the common link in both 1997 and 2014. Each time, the BoJ had to compensate 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, while keeping yield curves steep. The logic – to cap debt-service costs – will remain critical for an economy recording the developed world's highest government liabilities-to-GDP ratio, at about 230%.

Also, the authorities have long memories. Deflation-denial in the 1990s as the BoJ tightened contributed to a correction that's still playing out. Tumbling asset prices from 1991 contributed 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'). But, it took until 2001 to get its key policy rate down to 0.1%. And, with deflation expectations embedding and land prices falling, real rates stayed positive. This needed more unconventional tools, including government bond QE. A symbiosis thus started, where the MoF, presiding over escalating government liabilities, became reliant on the BoJ.

So, at ¥80trn *p.a.* ($735bn) in asset purchases, the vast bulk (93%) being JGBs, the BoJ will continue mopping them up at twice the pace of new supply. Depending on where global yields go, this ¥80trn may vary, reflecting requirements to meet the low yield-target. Any rise at a zero/negative yield (likely) should, thus, be seen as a loosening. For BoJ Governor Kuroda, there is no QE "reversal" until a +2%yoy CPI (latest, just +0.2%yoy) is the norm – presumably driven by demand, not taxes/costs. Under him, the BoJ has doubled its share of JGBs outstanding to 50% (chart 6), leaving institutions chasing riskier assets and looking overseas for bonds. The MoF will now hope that, by keeping nominal growth above the average long-term interest rate, it can borrow without raising the debt ratio. This leaves some believing the BoJ will be the last to ever stop QE.

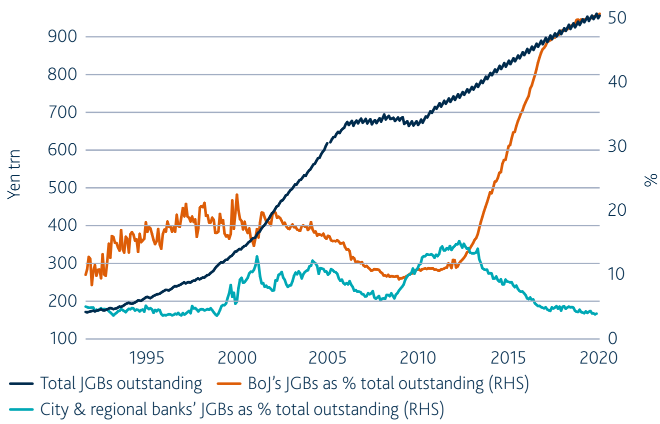
So, the spring wage-round (*shunto*) will again be critical, and hopefully perkier than the 2% one-off wage hikes in 2014-19. Chart 7 suggests sustained wage-growth would probably lift the CPI, given the past nine years' unemployment falls, and persistent steepness of the Phillips Curve. BoJ research concurs by identifying a negatively sloped curve, and greater long-term wage responsiveness than in the US. But, in Japan's liquidity trap, it's doubtful that easier money will prove any different, in terms of sparking wages and breaking the deflationary psychology – even with a likely demand-fillip from hosting the Summer Olympics and Paralympics.

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

% yoy unless stated	'15	'16	'17	'18	'19e	'20p	'21p
Real GDP	1.3	0.6	2.0	0.8	0.8	0.5	0.0
Private consumption	-0.2	-0.1	1.1	0.4	0.8	-0.1	-0.2
Business investment	3.3	-1.5	3.9	3.9	2.3	1.0	0.3
Industrial production	-1.1	0.2	2.9	1.0	-1.0	1.0	0.5
Consumer prices	0.8	-0.1	0.5	1.0	0.7	1.2	1.5
Unemployment rate (%)	3.4	3.1	2.8	2.4	2.3	2.4	2.5
Current account (% GDP)	3.1	4.0	4.2	3.5	3.4	3.2	3.0
Gen budget balance (% GDP, FY)	-3.6	-3.5	-3.0	-2.5	-3.4	-3.4	-3.6
BoJ target rate (yr-end, %)	0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10

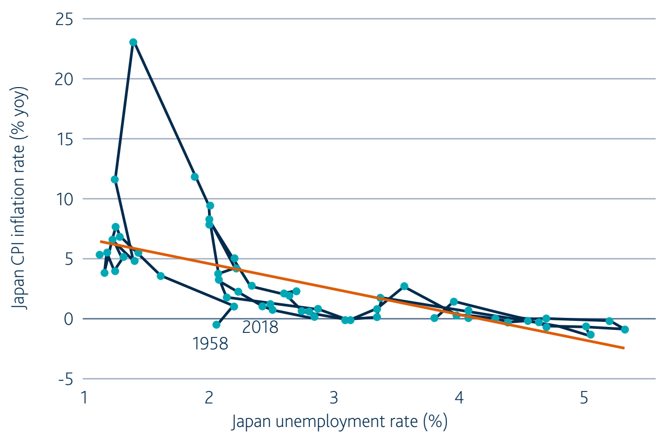
Source: National data, Hermes Investment Management, OECD, & Consensus Economics

Chart 6. The BoJ's overwhelming share of its domestic bond market
JGBs outstanding (¥trn) on LH scale, & BoJ & domestic banks' shares (%) on RH scale



Source: Refinitiv Datastream, based on BoJ

Chart 7. The outcome of the spring wage-round will again be critical
Fitted 'Phillips curve', showing trade-off between unemployment rate & CPI inflation



Source: Refinitiv Datastream, based on Ministry of Internal Affairs & Communications

EUROZONE

With growth tailing off and the UK opening the EU trapdoor, the challenge for new leaders will be to avoid political divergence, as populism and reform-fatigue build. The ECB, doubting that deflation's beaten, is reopening QE – albeit, at €20bn per month, at a quarter of 2015's run-rate. Opposition to more will persist within the Governing Council. Its effectiveness hinges on capping long rates, and, with two thirds of private borrowing long-end driven, stimulating demand. But, this attacks the symptom. The solution – securing the economic union that a monetary union demands – may be years away (chart 9). After nine years of austerity, voters' enmity is more visible. Hopefully for growth, Ms Lagarde, like Mr Draghi, will offer a 'green light' to governments that have "*fiscal space*" to take back the baton from the ECB, and to administrations elected on more populist mandates.

Time to open the fiscal box...

Significantly, France has passed a less contractionary budget for 2020 – allowing larger-than-planned structural deficits on only modestly reduced growth-assumptions. This is the second year of a lighter touch, having watered down its revenue-raising (fuel taxes) to appease the *gilets jaunes*. Italy's latest coalition from August appears less euro-sceptic than its predecessor, though, with an anti-establishment representation in M5S, it still offers risks for markets if confrontation with the EU builds (e.g. migration). In practice, though, highly-indebted members like Italy and Greece, vulnerable to rising debt-service costs, have especial interest in resisting a volte-face that destabilises the euro.

Austerity has sliced the euro-zone's budget deficit from 6.2% of GDP in 2009 to less than 1%: easily below the 3% Maastricht test. This should make it easier for fiscally-prudent Germany to permit some zone-wide fiscal largesse as a counterweight to QE 'conservatism'. Germany's own coalition had been eying a fiscal sweetener (infrastructure, childcare) before Chancellor Merkel steps down by 2021, on top of €54bn of climate-change measures by 2023. If debt-financed (which at negative yield must be attractive), it would also help the ECB in undercutting its buyer's limit in 2020 of holding no more than a third of Germany's debt. Absence of a single fiscal-agency may complicate the process overall, but not preclude some autonomy within agreed, euro-friendly limits.

Looking back, Italy's referendum in December 2016 rejecting deeper government powers probably set the political tone to come. In 2017, tensions with Turkey threw up a new risk: where one country's issues (Turkey's referendum) spill over into another's (Netherlands' election). Spain has needed four general elections in just four years on regional-independence issues and budget failure. The good news, however, is that Spain, Italy, and other peripheries' *macro* shortfalls versus Germany are reducing rapidly. As a guide, chart 8 uses our alternative 'Misery Indices' based on relative CPI and unemployment shifts. (See our *Europe's highly-charged year* report, April 2017). Yet, France's gap is closing more slowly than theirs, justifying the need for more of Mr Macron's supply-side reforms.

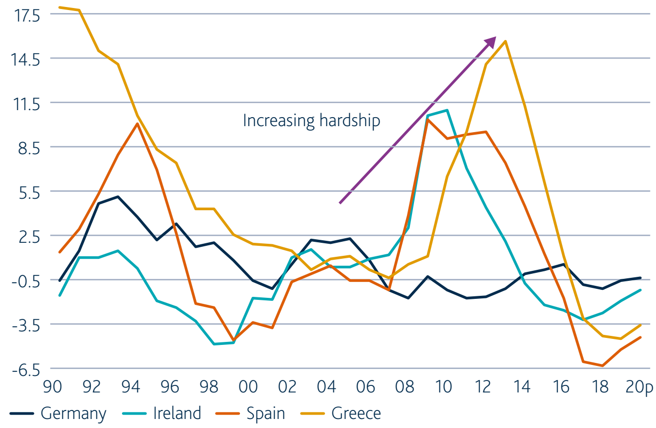
Furthermore, our 'Competitiveness Analysis' suggests euro-economies are still too disparate to rule out future strains. If all its obligations (including to other members/IMF) are to be honoured, for example, Greece's government liabilities-to-GDP ratio could nearly double between 2030 and 2060, to 275%. This is higher than Japan's. Further debt restructurings thus look inevitable. As does the continued dilemma between minimising debt-costs within the euro, or exiting it to reclaim growth. Time to open the fiscal box!

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

% yoy unless stated	'15	'16	'17	'18	'19e	'20p	'21p
Real GDP	2.0	1.9	2.7	1.9	1.1	1.2	0.9
Private consumption	1.8	1.9	1.8	1.4	1.2	1.2	1.0
Fixed investment	4.7	3.9	3.8	2.3	2.3	1.6	1.3
Industrial production	2.6	1.7	2.9	0.9	-1.0	1.0	0.5
Consumer prices (HICP)	0.2	0.2	1.5	1.8	1.2	1.7	2.2
Unemployment rate (%)	10.9	10.0	9.1	8.2	7.7	7.6	7.8
Current account (% GDP)	2.8	3.3	3.2	3.1	2.8	2.6	2.3
Gen budget balance (% GDP)	-2.0	-1.4	-0.9	-0.5	-1.0	-1.5	-2.2
ECB refi' rate (yr-end, %)	0.05	0.00	0.00	0.00	0.00	0.00	0.00

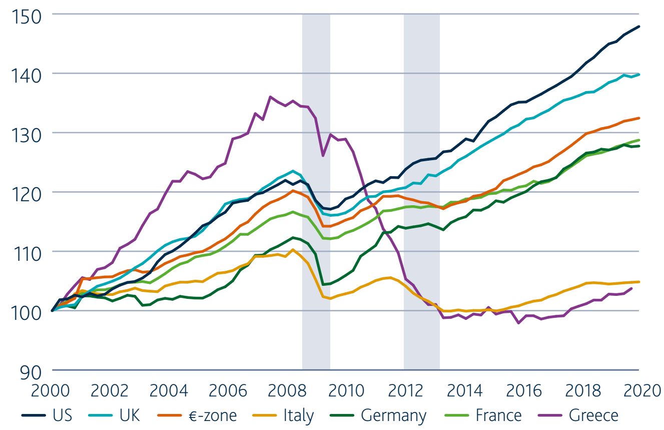
Source: National data, Hermes Investment Management, OECD, & Consensus Economics

Chart 8. The macro strains from the periphery have been easing...
The lower the 'Misery Index', the greater the relative economic improvement



Source: Hermes' MIs, based on Eurostat data, & Hermes, & OECD projections

Chart 9. But, it'll be years before they reclaim GDP lost with the euro
Real GDP levels, re-based to Jan 2000 (= 100). Grey denotes euro-zone recession



Source: Refinitiv Datastream, based on national data

UNITED KINGDOM

With Brexit uncertainty likely to drag on, economics – policy and performance – will continue to play 'second fiddle' to politics. The situation is fluid, but, under current conditions and with Parliament so far unaccepting of a 'no-deal' Brexit, the door is open for a Brexit process that may take years. Even if the existing, or even a new, EU deal can be fast-tracked by 31 January, it would likely be a precursor to sorting out the various legal, trade, and regulatory systems, including the Irish border, during a transitional period that could extend beyond 2022. And, depending on the make-up of any new administration or interim government after the 12 December election, this could even involve another referendum.

Brexit means looser policy on three fronts...

Eventually, to maintain ties, some form of 'satellite' alignment (e.g. Norway's) and/or part-access to the Customs Union (Turkey) or Single Market (Canada) may be ruled in. Canada's took seven years for manufacturers only. But, each option would have strings attached (e.g. labour mobility), making it unpalatable to some. New bilateral deals (e.g. the US) cannot be activated until Brexit is cleared, leaving WTO-terms (with import duties/controls) as a stop-gap.

Meanwhile, business and even retail activity are now softening. UK growth dropped from the top of the G5 quarter-on-quarter growth-table in H2 2016 (just after the referendum) to the bottom by H2 2017, with its 'recovery' since obfuscated by stockpiling. This raises the prospect of looser policy from up to three fronts. The nuance since the referendum has been a loosening of the fiscal reins relative to plans (chart 10). An even lighter touch came from September's Spending Review. And, even though a full Budget is deferred, the Review plus other parties' commitments suggest ex-Chancellor Hammond's pledge, of keeping the structural deficit sub 2% of GDP in 2020/21, is broken. This is with Brexit dues yet to be negotiated.

This leaves the BoE putting as much store on tactics as medium-term strategy. We expect it to tentatively follow a slow rate-cutting path in pursuit of the "smooth Brexit" it craves. It will be wary of 'squandering' what ammunition it has (75bp of rate cuts, more QE) should Brexit threaten the system. But, if protectionism spreads, its hand will be forced, keeping liquidity plentiful. And, with the CPI again driven by cost not demand, the MPC will easily have fallen short of its 'Goldilocks' Bank rate of 2% during Carney's tenure, ending in February. 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, the 'Holy Grail' remains real-wage growth. MPC members hope that productivity – flatlining since the crisis – begins to lift, justifying higher wage claims. Critical will again be spring's cluster of pay settlements, and any impulse to the public-sector from the Budget.

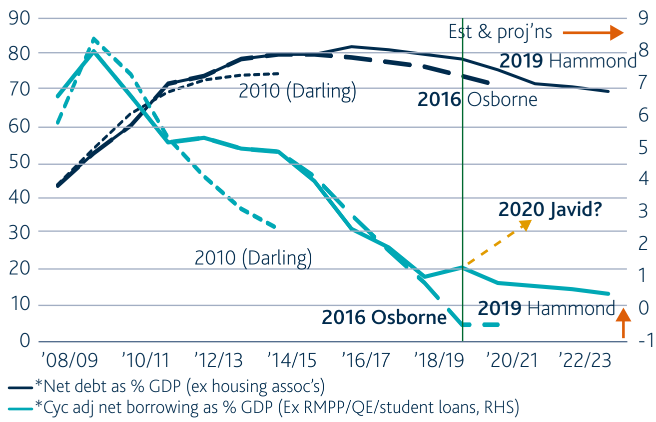
However, this is not guaranteed. BoE staff believe it takes four years for higher import prices to be fully passed on to a CPI basket that's about one-third imported. This shortfall – apparent three years after sterling's initial dive – is presumably still being felt in exporters' margins. This may not be reversed, even if Brexit is resolved quickly. Chart 11 reminds us that, in the longer-term, no major economy has loosened policy more than the UK. And, given the inflation premium, there's probably little coincidence the pound has underperformed. Which suggests little sustained upside for sterling after a relief rally, even when Brexit's cloud starts to lift.

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

% yoy unless stated	'15	'16	'17	'18	'19e	'20p	'21p
Real GDP	2.4	1.9	1.9	1.4	1.2	1.0	0.8
Household consumption	2.9	3.8	2.3	1.6	1.4	1.1	0.9
Fixed investment	3.7	3.6	1.6	-0.1	0.3	0.5	-0.3
Manufacturing production	-0.1	0.2	2.2	0.4	-0.8	0.3	0.0
Retail prices index	1.0	1.7	3.6	3.4	2.6	2.9	3.3
Consumer prices	0.0	0.7	2.7	2.5	1.9	2.3	3.0
Unemp, ILO rate (3m av, %)	5.4	4.9	4.4	4.1	3.9	4.1	4.3
Current account (% GDP)	-4.9	-5.2	-3.5	-3.9	-4.3	-4.1	-3.9
Gen budget balance (% GDP, FY)	-4.2	-2.8	-2.7	-1.9	-1.5	-2.3	-3.0
BoE Bank rate (yr-end, %)	0.50	0.25	0.50	0.75	0.75	0.25	0.25

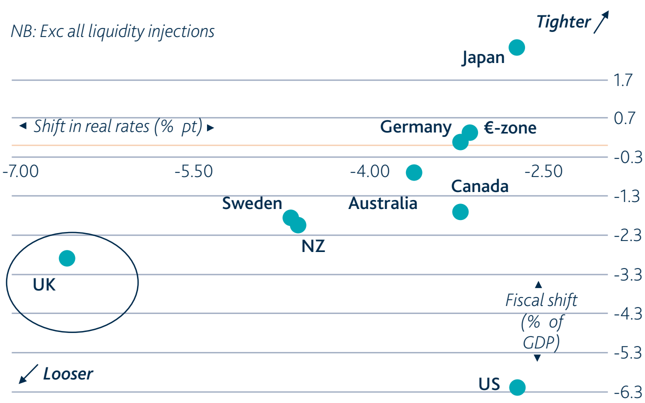
Source: National data, Hermes Investment Management, OBR, OECD, & Consensus Economics

Chart 10. The UK's fiscal loosening will not be halted by Brexit savings
Recent Chancellors' underlying deficit & debt plans (*adj for various definitional changes)



Source: OBR (Mar 2010, Mar 2016, & Mar 2019 Budgets), & *Hermes calculations

Chart 11. No major economy has loosened policy more than the UK
Shifts since 2000 in real rates (using 3m Libor, CPI), & cyc adj (2019e) budget balances



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

CHINA

The swing since mid-2018 in China's macro policy – from the austere, supply-side reforms of 2016 and 2017, to an increasingly accommodative pro-demand programme – should accelerate. In principle, President Xi's hand (he now looks entrenched even beyond the twentieth National Congress in 2022) allows him to address the financial risks flagged up at annual Central Economic Work Conferences – of limiting asset-price bubbles, taming corporate debt, and managing shadow banking. But, with the economy slowing as 2017's credit tightening and new trade restrictions feed through (chart 12), and trade negotiators needing to rebuff concerns about anti-globalisation policies, preserving growth will be the priority.

Ruffling the US administration's feathers...

Onus will thus remain on China's traditional levers for keeping GDP close to target, including agricultural subsidies and bringing forward infrastructure projects. Politburo sessions should reaffirm its growth objectives, with little more than 6%yoy now needed to have doubled 2010's GDP level and per capita income by 2020. These have been the core aims since 2015. And, with GDP since averaging +6.7%yoy, there's room later to address the financial risks, and shore up the renminbi.

However, as trade tensions escalate, harm to China and the US looks inevitable. The impulse from allowing China's money rates last year to fall over 200bp has been reinforced by taking 350bp off banks' reserve ratios. These appear obvious sweeteners into US trade talks, but, they also aid SMEs facing a strong upturn in real borrowing costs (chart 13). More will follow, and fiscal policy may also be loosened again, though there are early signs 2018-19's measures (manufacturing tax cuts, income tax reform) may be helping to arrest the slowdown (chart 12).

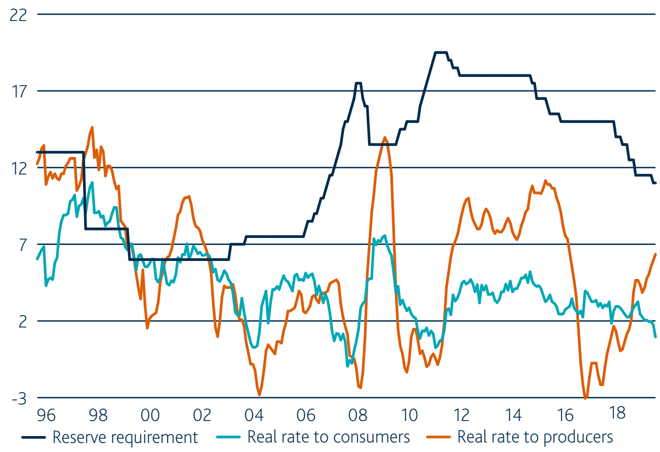
Yet, PBoC will only reluctantly weaken the renminbi, given the risk of imploding China's corporate/banks' balance sheets exposed to USD debt. The RMB has been allowed to fall fastest during bouts of global influence, such as Brexit fears and higher US inflation-expectations (2016), and trade spats (2018-19). The persistence of these as China's bilateral surplus with the US builds (chart 14) suggests further RMB downside. Initially, the PBoC would likely stem this fall by tightening capital controls and delving into its $3.1trn reserves. But, this would surely question China's commitment to buying US Treasuries (17% of international holdings), and, unless offset elsewhere (US QE?), indirectly raise US mortgage rates priced off long yields. This uneasy symbiosis is a reassuring disincentive for markets, but it may not prove a mutual deterrent. In which case, non-deliverable forwards implying an only 3% USD/RMB fall three-years out look complacent. The PBoC's preference is to avoid haemorrhaging as in 2014-17, as individuals again eat into their $50,000 per annum outflow cap. But, the game-changer is US tariffs.

And, it remains to be seen how a fraying US relationship exacerbates differences over North Korea, Taiwan, Hong Kong, and the South China Sea. It could become increasingly fractious. In which case, currency depreciation, lower reserves, selective defaults, and a lower, sub-6% growth target may prove damage limitation for Xi if he can blame them on the US! While, in return, his assertiveness on climate change, furthering his 'Belt and Road' initiative, and call to establish China as a "leading global power" may continue to 'ruffle the US administration's feathers'.

Chart 12. Stabilisation at lower activity rates...
Shows coincident indicator lagged nine months, & M2 growth (%yoy)

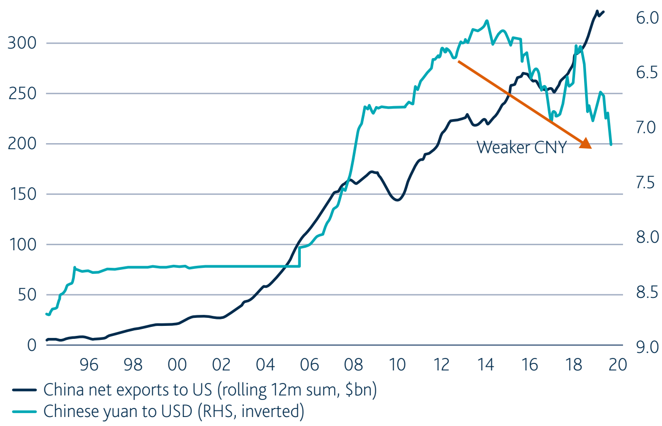
Source: Refinitiv Datastream, based on NBS, & PBoC data

Chart 13. ...Offers more justification for monetary loosening...
China's 3-5yr lending rate deflated by CPI/PPI, vs RRR for small banks (%)



Source: Refinitiv Datastream, based on NBS, & PBoC data

Chart 14. ...But, PBOC will only reluctantly weaken the renminbi
China/US bilateral trade surplus, 12m total, $bn. USD/CNY on an inverted axis



Source: Refinitiv Datastream, based on WM/Reuters, & IMF data

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