Will the debt matter?...

Economic outlook

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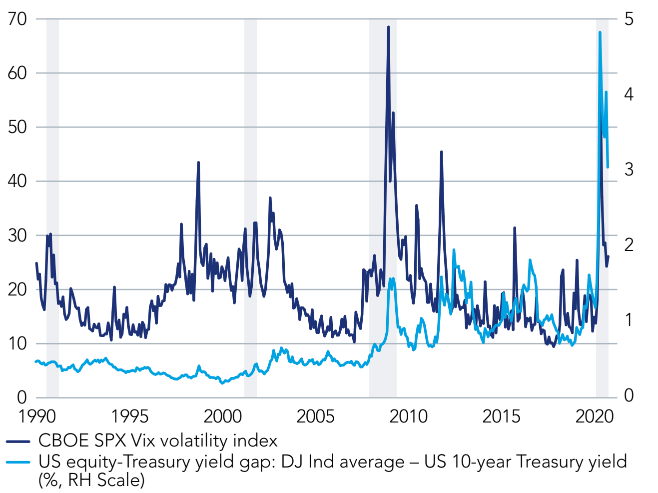
Main points

- The strong recovery in equity markets looks driven more by record fiscal stimulus, ultra-low bond yields, the prospect of even easier money, and hopes they can propel future growth, rather than any convincing sign of economies returning to 'normal'. Admittedly, the data are becoming 'less awful', though this may have been a relatively low macro-hurdle to clear, after Q2's 'eye of the storm' wiped out years of economic growth.
- How the situation plays out, of course, rests on more than finance, and analysts' implicit assumption that Covid-19 is nearing its (only) peak probably depends still on a vaccine yet to be found. Reflecting this, expectations of swift 'V'-shape macro recoveries have morphed into something closer to a 'U' or 'W', which seem more likely.
- For this and other reasons, policy will stay abnormally loose. Central banks, long frustrated by inflation's absence, are starting to question their traditional reaction functions, such as CPI targets and Phillips Curves. Mandates could change, and the latest tilts in US Fed, BoJ, and BoE policy could all herald more widespread paradigm shifts.
- None of these would, meaningfully, tighten conditions. We estimate the US Fed and BoE will continue to run negative policy rates (currently -10% and -6%) when QE is considered. This confirms by far the loosest overall stance we've known, highlights how little correction there'll be, and questions the need for either of them to follow the BoJ and ECB onto negative 'headline' rates.
- Either way, the legacy will be debt build-up, which was amassing even before the virus. The US, euro-zone, and UK governments' net debt is now approaching three times Japan's when it entered a 'lost-decade'. Thankfully, like Japan, all are in local currency, implying default-risk is next to zero.
- This gives their governments time to put growth and inflation generation ahead of more direct ways of addressing the debt. Such a relaxed approach would be akin to dealing with the UK's post-War debt that started at 250% of GDP, with the advantage this time of no longer having the USD-denominated obligations that contributed to our having to borrow from the IMF in 1976.
- Despite this, governments cannot be complacent. Not only could debt drag on growth, the 'kindness of strangers' will also hinge on yield/ratings considerations. Yet, not to 'crowd out' recovery, funding costs will have to be held down, adding to political incentives to keep the printing presses running. And, even if growth is preserved, competing demands may relegate infrastructure and Green initiatives, while debt ownership raises political tensions, and strains in many emerging markets.
- This suggests QE will be even harder to kick, potentially further widening disparities, and blurring the operational distinction between the monetary and fiscal authorities. The issue then is whether hyper-inflation beckons, or that, with ultra-low rates/QE part of the problem, we move closer to 'a Japan'. We suspect the latter. Either way, with each involving malfunctioning economies, it seems likely that 'sweeping ever-growing debt under the carpet' will at some stage trip up policy-makers…

Chart 1. Elevated equity markets have been powering back…

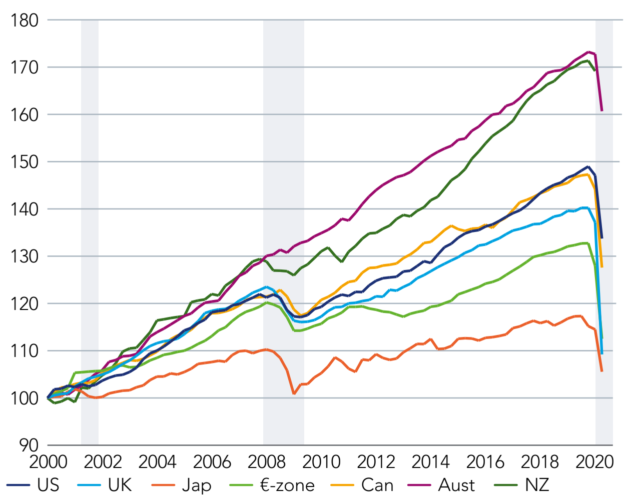
US equity-bond yield gap (using DJ Industrials & 10-year Treasury), vs VIX volatility index



Source: Refinitiv Datastream

Chart 2. Even though the virus is wiping out years of economic growth

Real GDP level re-based to Q1 2000 (=100)



Source: Refinitiv Datastream, based on national data

Comment

The strong recovery in equity markets (chart 1) looks driven more by record fiscal stimulus, ultra-low bond yields, the prospect of extended monetary loosening, and hopes they can propel future growth, rather than any convincing sign of economies returning to 'normal'. Admittedly in Q3, the second-tier data (e.g. PMIs, jobless claims) are becoming 'less awful', helping stock indices, many commodities, and the safety-first US dollar back toward pre-virus levels. But, while encouraging, this may have been a relatively low macro-hurdle to clear, after Q2's 'eye of the storm' that wiped out years of economic growth (chart 2).

How the situation plays out, of course, rests on more than finance, and analysts' implicit assumption that Covid-19 is nearing its (only) global peak probably depends still on a vaccine yet to be found. To reflect this and the severity of this year's economic hit, GDP-projections have been moderating, despite the increasing stimulus. As chart 3 for the UK attests, expectations in April of swift 'V'-shape recoveries for most of the G7 have morphed into something closer to a 'U' or 'W', which seem more likely. China may be the exception, but even its state-led GDP-bounce stands to be eroded by beggar-thy-neighbour policies (page 14).

Sweeping it under the carpet...

With Q2 data confirming G7 recessions (two consecutive quarters of falling GDP), base-effect would, at some stage, redeliver growth. But, more telling, will be how painlessly GDP *levels* can return to trend. Chart 2 shows the depth of Q2's hit. After needing five or six years after 2008-09 to reclaim their real GDP, the virus has at a stroke taken the US's back to 2014 levels, the UK's to 2003, and stolen another 'growth decade' from Japan. Even before the virus, consumers in Japan (with deflation), and Italy and Spain (locked in the euro) had yet to recover their pre 2008-09 consumption. Now, their respective real consumption is having to start again from 2001 and pre-euro levels.

And critical to recovery will be the rapidity of labour's response. US job losses have been 'eye watering', chiming with 1930s unemployment rates. Even if 60% of these prove 'temporary', the 8% unemployment rate on a full, immediate rehire would be more than double February's. And, rapid labour downturns do not guarantee sharp recoveries (chart 4). Thankfully, the labour data are improving as furloughed workers return. Yet, even if jobs continue to be clawed back at the current pace, it would take another nine months for the net 12 million workers displaced since February to return. This assumes a full rehiring with no further lockdown, and return of the millions disappearing from the workforce. Delay may not be helpful to a President seeking re-election (page 6).

And, it remains to be seen how spendthrift returning furloughed workers can be, given difficulties in extending extra unemployment benefit, other benefit-cuts (predominantly healthcare), finding the lowest earners for support, and the 11 million 'undocumented' workers. Early clues included one-half of low-income US households having lost a job/taken a pay cut because of virus, with 70% using the funds for paying bills, not discretionary spending. In the UK too, support has rightly helped cash-flow. But, the extension there of 'furloughing' to October, even with firms contributing, could take its fiscal cost to £84bn (3.9% of GDP). And, taking all virus measures together, the budget deficit balloons to £370bn in 2020/21. At over 15% of GDP, this is easily a post-War high, and dwarfs the 2.4% expected in March (page 12).

For this and other reasons, policy will stay abnormally loose. Central banks, long frustrated by inflation's absence, are starting to question their traditional reaction functions, such as CPI targets and Phillips Curves. Mandates could, thus, change, and the US Fed's tilt to average, rather than fixed, inflation targeting, the BoJ's explicit yield-targeting, and BoE now considering QT before eventual rate hikes, could all herald more widespread paradigm shifts.

None of these would, meaningfully, tighten conditions. *Our Policy Looseness Analysis* quantifies the impact of monetary and fiscal measures on the overall policy-mix. Based on central banks' current trade-offs plus actual and expected fiscal packages, we estimate the US Fed and BoE are already running true policy rates as low as -10% and -6% when QE is considered (-12% and -7% in real terms). This confirms by far the loosest overall stance in nearly three decades of data (probably post-War), and highlights how little correction there'll be in 2021. It also questions the need for the US Fed and BoE to follow the ECB and BoJ onto negative 'headline' rates.

And, while fiscal expansions vary in speed and scale, it's difficult seeing how these can be reversed without unintended consequences. Front-runners have been the US, Japan, and UK, with packages equivalent to about 14%, 23%, and 6% of respective GDPs, with China favouring a more cautious 3.6% of GDP programme to avoid the over-stimulation of 2008 (page 14). Impressively, the euro-zone will near double its initial 4.3% of GDP if its Recovery Fund remains inoffensive to sceptics of 'debt-sharing'. This plus maintaining QE at the current, faster rate will hopefully avoid the macro divergence of 2010-'13's funding crisis (page 10).

Either way, the legacy will be debt build-up, which was amassing even before the virus. Higher government debt ratios now look inevitable for 2020 and beyond (chart 5), in both gross and net terms. (Net debt excludes Sovereigns' financial assets, ownership, loans, and gold). In 2019, the US, euro-zone, and UK governments' *net* debt averaged 76% of GDP, more than twice Japan's (34%) when it entered a lost-decade in the mid-1990s. Japan 'gets away with it' from having all its JGBs local-currency denominated, held predominately (97%) by a domestic investor-base less sensitive to yield/foreign-currency ratings. Thankfully, the US, euro-zone, and UK's too are in local currency, also implying default-risk is next to zero.

This gives their governments (especially those facing voter enmity) time to put growth and inflation considerations ahead of more direct ways (tax rises, spending cuts) of addressing the debt. Such a relaxed approach would be akin to dealing with the UK's post-War debt burden that started at 250% of GDP. And an advantage this time is no longer having the USD-denominated obligations that contributed to our having to borrow from the IMF in 1976.

Yet, governments cannot be complacent. First, debt accumulation may gradually drag on growth. Chart 5 shows that *gross* debt-to-GDP ratios were, even before the virus, exceeding the 77% that the World Bank estimates is a 'tipping point', after which growth starts to be held back as every additional percentage point of debt-to-GDP, thereafter, clips annual GDP by 0.02% point (World Bank, June 2013). While small initially, this could snowball as debt accumulates. Also, chart 5 shows OECD projections for gross debt/GDP under both its single and double virus-peak scenarios (June 2020), reminding us that debt-reduction will probably need medical, not just economic solutions.

Second, with up to 40% of US, core euro-zone and UK government debt owned internationally, *"the kindness of strangers"* (Carney) will hinge more on yield/ratings considerations than Japan's has. The UK's net debt for 2020 will exceed 100% of GDP; its highest ratio since 1963. In 2019, it was 80%. Unless growth takes off, we would by 2030 approach our 250% post-war high if debt continues accumulating around this pace. Without stronger, sustained demand-growth, this would wipe out officials' hopes of eroding the debt via inflation.

Third, not to 'crowd out' private-sector recovery, debt-funding costs will have to be held down if a vicious circle – of lower growth, lower tax revenue, higher deficits – is to be avoided. Here, the debt would matter. Crowding out's biggest risk, though, is when funding costs run significantly ahead of inflation, such as in the 1970s. But, unless *deflation* expectations set in (boosting real costs), this seems at variance with currently low/negative funding costs. And, with the printing presses ready and leaders facing short political cycles, certainly relative to average debt maturities (Japan's is about 10 years, the UK's 16 years), there's incentive to keep QE going to avoid throwing out the 'baby' (growth) with the 'bath water' (raising taxes/cutting spending). US Presidential candidate, Biden, stands out by proposing tax-hikes, but only as part of an income-redistribution programme (page 6).

Yet, fourth, even if growth is preserved, competing demands on the public purse and realisation that deficits have to be addressed at some stage as ratings/yields come under pressure (e.g. UK Chancellor Osbourne in 2010-13), may relegate other priorities, such as infrastructure and Green initiatives, into the background. One palliative might be to tailor future fiscal stimuli (or withdrawals) to environmental performance. (See our *Building back better: why climate action is key to a resilient recovery* report, May 2020.)

Fifth, debt-ownership could raise political tensions. One early warning could come as the international 'blame-game' intensifies. Bargaining over the US's gross $24trn (117% of GDP) debt-ceiling for mid-2021 may flag up China's $1.1trn claim on it. This would raise friction as China prepares for its 2022 National Congress. In retaliation, any RMB-weakening then risks imploding China's corporate/banks' balance sheets exposed to USD debt, so the PBoC would likely stem it via capital controls and delving into its $3.1trn reserves. This would surely question China's commitment to buying US Treasuries (17% of international holdings), and, unless offset elsewhere (US QE?), raise US mortgages typically priced off long yields.

Finally, for many emerging markets (EM), the outlook may be less rosy. The World Bank estimates a lower, 64% of GDP, tipping point for EM economies, before the same (0.02%point) annual growth hit comes from every percentage-point debt-rise thereafter. This year's GDP-contraction will be prolonged if virus catch-up in the more densely-populated Brazil, India, and Russia persists. And, even after that, in a potentially more protectionist, stronger USD, environment. Vulnerabilities lie with those non-commodity exporters with high exposure to short-term external debt and foreign saving needs, such as Argentina, Turkey, and Ukraine. But, for others, external debt-ratios are lower, with few currency pegs to protect. And, as their domestic debt climbs, they too can run QE.

All this suggests QE will become even harder to kick. If it continues to boost asset prices over wages, this could further widen wealth disparities. With even more bond supply, Japan – after 22 years – will probably have to accelerate QE just to 'stand still' (page 8). In 1951, the US Treasury-Federal Reserve Accord was the reason for stopping US QE after 14 years. This will not be repeated, and could even be revoked, formalising the dependence QE-governments have on their central banks. So, in an even-higher-debt world, a challenge will be keeping clear the operational distinction between the monetary and fiscal authorities, as bond issuance swells, and government addiction to QE builds.

The issue then, of course, is whether hyper-inflation beckons as institutional credibility is questioned, currencies are debased, and memories rekindled of Weimar Germany in 1923, Argentina after the 1980s, and Zimbabwe in 2007. Or, alternatively, that with ultra-low rates and QE now part of the growth-problem, not the solution, our liquidity trap takes us nearer the Japan route. We suspect the latter. But, either way, with each involving malfunctioning economies, it seems likely that 'sweeping ever-growing debt under the carpet' will at some stage trip up policy-makers.

Chart 3. Consensus is edging away from 'V-shaped' recoveries

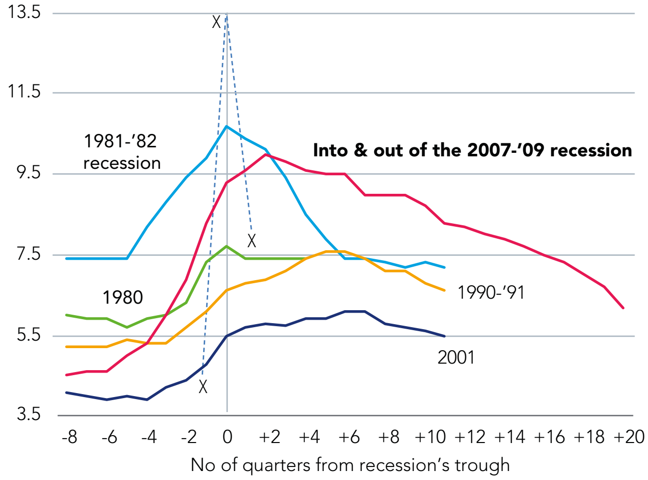
August consensus for UK economy vs April in parentheses. Rates/yields are for Nov 2020 & Aug 2021

% yoy unless stated	'15	'16	'17	'18	'19	'20p	'21p
Real GDP	2.4	1.9	1.9	1.3	1.5	-9.9 (-5.4)	6.4 (4.7)
Household consumption	2.9	3.8	2.3	1.6	1.0	-11.5 (-5.8)	7.1 (4.3)
Fixed investment	3.7	3.6	1.6	-0.2	0.7	-15.6	6.0
Manufacturing production	-0.1	0.2	2.3	0.9	-1.7	-11.9	7.5
Consumer prices	0.0	0.7	2.7	2.4	1.8	0.7	1.4
Unemp, ILO rate (3m av, %)	5.4	4.9	4.4	4.1	3.8	6.5	7.3
Govt budget balance (% GDP)		-2.8	-2.7	-1.9	-2.8	-14.5 (-7.9)	-7.0
Govt gross debt liabilities (% GDP)*					85	102 (96)	101
10-year Govt bond yield (yr-end %)		1.2	1.2	1.3	0.8	0.3	0.5
3-month rate (yr-end, %)		0.4	0.5	0.9	0.8	0.2	0.3

Source: National data, IMF* & Consensus Economics projections (p)

Chart 4. Unemployment in US recoveries

Unemployment rate (%) into & out of recessions. Years are NBER-defined recessions



Source: Federated Hermes, based on BLS, & NBER data

Chart 5. Meaning the legacy is debt build-up

Government gross & net liabilities as a % GDP. Projections under two virus scenarios. [1]1998 data; [2]2000 data

		1997		2019		2020p		2021p	
	Moody's local ccy	Gross	Net	Gross	Net	Gross		Gross	
						Single hit	Double hit	Single hit	Double hit
US	Aaa	62	44	109	85	129	132	133	140
Japan	A1	102	34	225	126	244	248	248	257
Euro-zone	n/a	81	51	104	63	121	125[3]	120	127[3]
UK	Aa2	55	33	116	80	138	143	136	149
Greece	B1	96	70	201	141	221	233	215	229
Italy	Baa3	129	101	156	122	181	195	178	192
Iceland	A2	47[1]	17[1]	63	6	73	73	77	79
Ireland	A2	61[1]	41[1]	72	44	85	87	88	96
Latvia	A3	53[2]	n/a	44	17	51	53	52	58
OECD av		*72*	*41*	*110*	*66*	*127*	*131*	*129*	*137*

Source: OECD projections/simulations (p), Federated Hermes extrapolation[3], & Moody's Investor Services

US

With high hurdles still to be cleared before restoring the economy to health, the macro data will prove only partially helpful to a President seeking re-election. The initial two bi-partisan election-year fiscal relief-packages, near $3trn (14% of GDP) in total, were not unprecedented, with a Republican President/Democrat-led House having passed a $152bn (1% of GDP) package in 2008. But, with obfuscation over a third, a $2trn package, and Mr Trump's approval historically low and stable (40-45%), re-election on 3 November may need him to re-attract centrists, or step up the one-nation policies that hold his base.

The latter approach would probably contrast with Democratic nominee Biden's, who, while unlikely to advocate unilaterally rolling back existing trade restrictions, would probably set a more collaborative tone. This could include relying more on allies to help push back on China, assuaging, though not removing, the global protectionism risks that keep us cautious on world GDP-growth. But, it remains to be seen how vehement Biden would be, given the need to tap into/hold onto Trump's core base, and how quickly allies' confidence in the US on trade and climate change can rebuild, following the highly visible, stand-alone approach to foreign policy under Trump.

After the election…

As a guide to possible market reaction, we summarise the Presidential candidates' main macro differences, where chart 6 is intended to be illustrative rather than exhaustive. Thus far, Mr Biden as the more 'middle of the road' candidate appears to harbour no obvious radical agenda, suggesting the two most immediate macro nuances will be centred on trade (as above), and fiscal policy. If so, growth assets may *initially* welcome a Trump victory, given the implied policy continuity, loose fiscal stance, and accommodating US Fed *etc.* Longer-term, though, the veneer may come off if beggar-thy-neighbour policies globally are stepped up (our base case).

Fiscally, even after record packages, neither candidate expresses urgency for correction as an end in itself. In the short term, both sides advocate further loosening. As part of the third package of relief measures, the Democrats' passing in the House of a $3trn bill to extend extra unemployment benefits and boost state funding potentially 'outspends' the Republicans' milder $1trn bill, that would extend benefits, but at a lower level ($200 p/week, vs $600).

Yet, Biden's pledge to thereafter raise both the main corporate (from 21% to 28%) and top personal tax rates (from 37% to 39.6%) make him look the more hawkish. Independent estimates suggest first-round revenue-increases from these centred on $3.6trn over a decade. These would effectively take back this year's 'stimulus', if implemented from 2021, with a long-term GDP-hit of up to 1.5%point (though, this ignores redistribution effects). Biden's approach, thus, contrasts to the headline tax-cutting campaigns of 2000 and 2016. Yet, with the *"…ultimate fiscal, economic, and distributional impact…depend(ing) on how newly raised revenue is spent or allocated"* (Committee for a Responsible Federal Budget, 20 July), his more populist programme of 'fiscal realignment' to redistribute income could work in his favour, politically. Biden, though, will be wary of the need to secure the minimum 51 seats to have policy impact.

And, especially given the challenge of restoring the six years of GDP growth (chart 2) and four years of consumption gains lost to the virus. Thankfully, the labour data – that have chimed with the 1930s – are becoming less 'eyewatering' as furloughed workers return. April's (the hardest-hit month) 20.8 million payrolls collapse compares to the latest (August) 1.4m increase. Yet, even if jobs can continue to be clawed back at around this pace, it would still take another nine months – easily beyond the election – for the net 12 million workers displaced since February to return. This assumes a full rehiring without further lockdown, and return of the millions disappearing from the workforce, but unregistered as unemployed. The 'under-employment' rate ('U6'), which includes those not searching but wanting to work/more (at over 14% vs 7% in February) may be slower to fall. And as we know from 2007-09, rapid job losses do not guarantee the sharpest recoveries (chart 4).

In theory, by now pursuing an average, rather than fixed, inflation target, the Fed can allow it to travel beyond its preferred 2% destination before tightening policy rates. This should give the recovery extra room to breathe. The challenge, though, may be getting inflation to get that far, given the disinflationary forces still working the other way, including slow labour recovery, sluggish productivity, and, in a liquidity trap, growth's insensitivity to low rates.

For this and other reasons (e.g. low inflation expectations), macro policy will have to stay abnormally loose. To gauge the impact of March/April's near $3trn package of tax, spending and liquidity measures, and our assumed further $2trn to come, as well as the Fed's open-ended QE, we update our *Policy Looseness Analysis* (see our *Tightening by doing nothing report*, May 2017). On the basis of the Fed's own policy rate/QE trade-offs, and our conservative assumptions of +$5trn QE in 2020 and just +$2trn in 2021, it suggests a true, QE/QT-adjusted funds rate currently closer to -10%, or -12% in real terms (chart 7). It, thus, also quantifies how far short we'll fall in 2021 – whoever's President – from taking the overall policy-mix back toward 2008 levels.

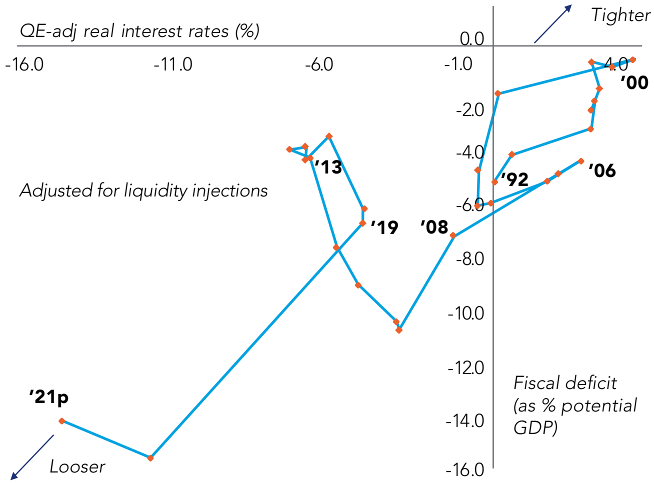
Chart 6. Presidential scenarios – possible macro implications

	Under Biden…	Under Trump…
GDP growth	**Less positive, short term**. Preference for higher corporate & personal tax rates infers some debt-management is prioritised over growth-enhancement.	**Short term positive, as advocates tax cuts**. But, could also step up trade & immigration curbs, with financial markets' reaction extending recession.
Fiscal stance	**Less expansionary than Trumps', offering more of a growth dividend**. Supports realignment: raising taxes at the upper end, & increasing welfare & infrastructure spending.	**Expansionary, & more front-end loaded**. Lower tax rates skewed to the higher-income end, partly offset by spending cuts. Congress, though, might try to limit big revenue hit.
Monetary policy	**Neutral**. Any fiscal correction would need low rates to support labour market & growth.	**Expansionary, keeping QE**. But, negative if he appoints a like-minded Fed chair, & rejects Powell's application in 2021.
Equities/ growth assets	**Negative short term, given uncertainty & potential tax hikes**. But, no meaningful change to Fed rate expectations.	**Positive short term, given loose policy, & no new regulations**. But, eroded later by extension of beggar-thy-neighbour policies.
Inflation/TIPS	**Less positive/neutral, given tax promises, but also possible softer US dollar**. Could raise federal minimum wage to lift spending at lower end.	**Positive, near term, given extended loose fiscal policy & QE**. Longer-term, closed-economy policies could trigger cost-push stagflation.
Conventional Treasuries	**Positive/neutral. Could extend** recession risk, & will assume more straightforward raising in mid-2021 of $24trn debt ceiling.	**Supportive short-term**, given more QE, threat of messy debt-ceiling negotiations & trade risks. Further out, curve steepening on feared Fed interference.
Trade policy	**Collaborative**, but no unilateral reversal of existing tariffs	**Allies distanced**, as trade & other restrictions accelerated.

Source: Federated Hermes

Chart 7. The US's macro policy mix including emergency measures

Using QE-adjusted funds target, core PCE, & cyclically adjusted fiscal balance. Unch rates in 2021



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

Japan

Virus-effects provide another reason for prolonging a policy-loosening spanning 22 years – regardless of PM Abe's resignation – consolidated by this year's three fiscal packages, totalling ¥127trn (23% of GDP).

Previous measures (a weaker yen, rounds of monetary and fiscal stimuli) had been helping, with real GDP till the end of CY17 rising for two years. This was the third longest stretch since the 1990s' asset-price collapse. The output gap closed, suggesting a return, if growth could be sustained above its 1%yoy 'potential', to economy-wide inflation (positive GDP-deflator). But, these measures were losing their edge even before the virus. With personal consumption already lacklustre into last October's sales-tax rise – contrary to its *frontloading* into 1997 and 2014's tax hikes (chart 8) – and the yen buoyed by safe-haven flows, deflation's-end is not assured. This may be especially unpalatable into Lower House Elections, which new PM, Suga may now bring forward from September 2021.

Debt deepens the reliance on the BoJ…

And, with the BoJ loathe to hurt banks by going further into negative-rate territory, QE will again have to do the monetary work. The BoJ's lifting of its commercial paper and corporate bond purchases, from ¥5.4trn to ¥20.4trn, now secures 23% coverage of those markets, and should absorb any new borrowing. And, given the MoF's revised plan now for ¥59trn of new JGB issuance in FY20 (year ending March 2021), the BoJ would have to almost double last year's ¥80trn annual purchases just to maintain the same run-rate, of mopping them up at more than twice the pace of new supply.

Depending on where global yields go, this ¥80trn will anyway vary, reflecting the need to meet the BoJ's near-zero 10-year yield-target. Any rise at a zero/negative yield should, thus, be seen as a loosening. For BoJ Governor Kuroda, there is no QE *"reversal"* until a +2%yoy CPI (latest +0.3%yoy) is the norm, presumably driven by demand, not costs. With the BoJ now expecting a return to deflation at least in its core-CPI (CPI ex fresh-food) of -0.5%yoy in FY20, its share of JGBs outstanding should surpass the current 54%. Institutions will thus look overseas, hopefully softening the yen.

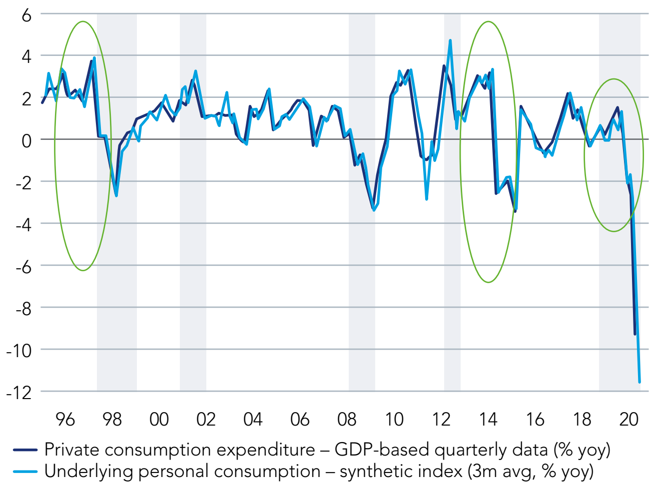
With the developed world's highest government liabilities-to-GDP, approaching 250%, the MoF faces the biggest hit from deflation. With deflation raising the real value of debt, and deflation and recession eating into nominal GDP, debt-ratios are blown up. The MoF now strives to get nominal growth (-8.7%yoy in Q2) back above the long-term interest rate, to borrow without raising the debt ratio. This leads some officials to believe the BoJ will be the last to stop QE. Encouragingly, land prices – critical for balance sheets and collateral – are creeping back up, with an average +0.8%yoy since 2016. But, as the demographics crimp productivity and tax revenue, this also questions any scaling-back of QE.

Added to that, 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 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'). However, it took till 2001 to get its key policy rate down to 0.1% and, with deflation expectations embedding and land prices falling, real rates stayed positive (chart 9). 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.

For inflation, the spring wage-round (*shunto*) was critical. Obfuscated by virus uncertainty, major companies have since been reluctant to offer anything perkier than the 2.0-2.4% one-off wage hikes in 2014-19. The irony is that, in Japan, more than in other G5 economies, sustained wage-growth would have more chance of lifting the CPI, given relative steepness of its Phillips Curve, and BoJ research identifying greater long-term wage responsiveness than in the US. Yet, in Japan's liquidity trap, it's doubtful easier money will prove any different, in terms of breaking the engrained deflationary psychology.

Chart 8. Personal consumption – only limited front-end loading this time

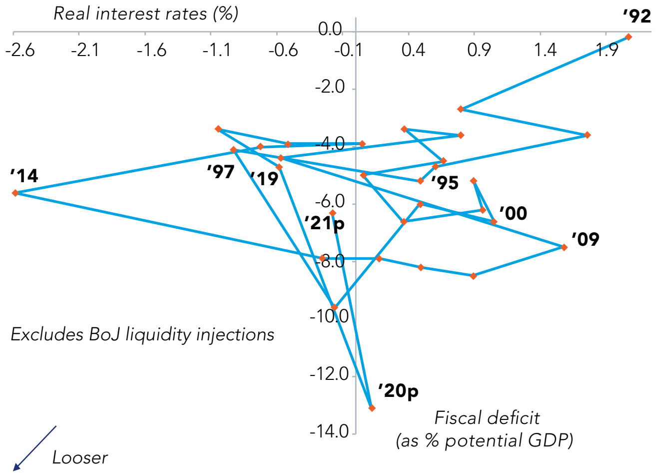
Synthetic & GDP-based real consumption, %yoy. ESRI-defined recessions in grey



Source: Refinitiv Datastream, based on Economic & Social Research Institute data

Chart 9. Japan's shift from overly tight, to historically loose, policy

Using 3m rates, CPI, & cyclically-adjusted fiscal balance. Projections assume no policy-rate changes



Source: Federated Hermes, based on OECD, & Bloomberg data, & consensus projections

Euro-zone

With risk-tolerance tested, the euro lifted by fiscal progress, and the zone's deepest recession ever (-11.8%qoq in Q2, vs 'just' -3.1% in Q1 2009), we assess whether the macro strains in the periphery are again holding back the core members. To do this, we update our 'Misery Indices' (MIs) to the end of 2022.

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 10 and 11 summarise our predictions to 2022. Rising MIs predict increasing economic hardship, relative to that country's past.

On this basis, it offers the following observations. First, after a marked deterioration in members' MIs during the global crisis, then improvement from 2014-2019, Covid-19 has unsurprisingly prevented the gains from being carried over in 2020. As a bloc, the euro-zone's (weighted) MI in 2019 was, at -1, the fourth consecutive year of improvement. Yet, higher unemployment and deflationary pressure should take this year's reading, at +2, back to its highest since 2015.

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 high base. For all though, 2020 dampens their relative positions, with only gradual improvement expected. In 2021, Italy will re-enter the above-average-misery zone in chart 10, where it lay for almost all the period since 2010. These are, admittedly, much improved on 2010-14, but less healthy than 2017-19, when the zone's weighted average MI was its lowest since the euro.

Most revealing, however, is what they say about convergence (chart 11). 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 thus reveal the two stages: from Maastricht in 1992 to the euro's birth; and thereafter, a re-widening as policy discipline waned.

Convergence after Maastricht was solid. We proxy it by tracking the highest and lowest MIs each year. Greece currently looks the 'happiest' economy *relative to its recent past* (GDP averaged just +1.3%yoy between 2016 and 2019), with Ireland relatively the 'least happy' (by being unable, at least in the short term, to maintain its impressive +6.4%yoy 2016-2019 average).

Greater convergence is shown by the narrowing gap between the two extremes. It suggests that despite virus pressures, 2020 should still see one of the largest degrees of convergence since the euro – albeit in the 'wrong direction' as far as economic wellbeing is concerned. A resumption of employment in 2021 with only modest inflation (as our consensus projections assume), would in theory cause our MIs to turn down again. Aspiring to this, though, probably rests on at least maintaining the ECB's faster QE run-rate (now at over €100bn per month; up from €20bn pre-virus, and €80bn during 2015), and implementing the zone's impressive, 'debt-sharing' Recovery Fund.

Ideally, weaker strains in the periphery would ensure the harmful macro divergence during 2010-'13's funding crisis is not repeated. The risk now, though, may be more political than economic. With 15 years of GDP-growth lost, MI's off the bottom, Brexit looming, and the euro-zone still lacking the economic union its monetary union needs, the challenge for new leaders (including Germany's in 2021) may be to avoid political divergence, as populism and reform-fatigue build.

Chart 10. The method & sample data behind our Misery Indices (MIs)

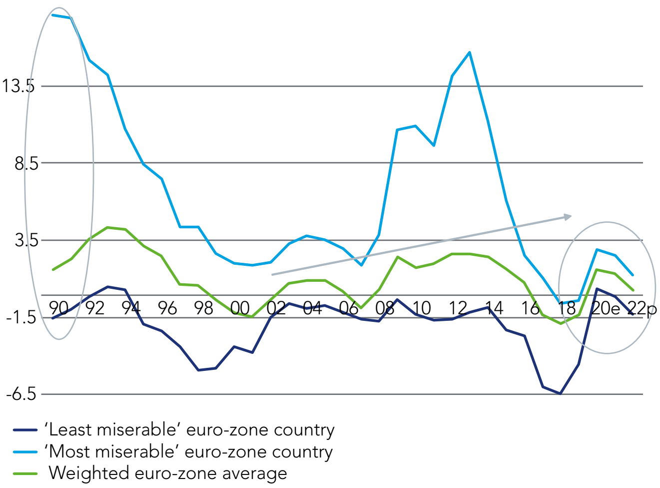
The lower the 'Misery Index', the greater the expected economic improvement

	2020e[1]		Unemployment rates						Misery			
									% point[2]			
	U rate	CPI	2015	'16	'17	'18	'19	5-yr av	2019	'20e	'21p	'22p
Ireland	7.8	-0.1	9.4	7.9	6.4	5.6	5.0	6.9	**-2**	**3**	**3**	**1**
Luxembourg	6.8	0.3	6.6	6.3	5.8	5.1	5.4	5.8	**0**	**3**	**1**	**0**
Portugal	9.5	0.0	12.4	11.1	8.9	7.0	6.5	9.2	**-3**	**2**	**1**	**0**
Spain	17.5	-0.2	22.1	19.6	17.2	15.3	14.1	17.7	**-5**	**2**	**2**	**0**
Austria	6.2	0.9	5.7	6.0	5.5	4.9	4.5	5.3	**-1**	**2**	**1**	**0**
Belgium	7.4	0.5	8.5	7.8	7.1	6.0	5.4	7.0	**-2**	**2**	**1**	**0**
France	9.9	0.5	10.4	10.0	9.4	9.0	8.5	9.5	**-1**	**2**	**2**	**0**
Italy	10.9	0.0	11.9	11.7	11.3	10.6	9.9	11.1	**-1**	**2**	**2**	**1**
Finland	8.0	0.2	9.4	8.8	8.6	7.4	6.7	8.2	**-1**	**1**	**1**	**0**
Germany	4.0	0.6	4.6	4.2	3.8	3.4	3.3	3.9	**0**	**1**	**1**	**1**
Netherlands	5.0	0.9	6.9	6.0	4.9	3.8	3.6	5.0	**-1**	**1**	**1**	**1**
Cyprus	9.3	-0.5	14.9	13.0	11.1	8.4	7.1	10.9	**-4**	**1**	**-1**	**-1**
Greece	19.3	-0.5	25.0	23.5	21.5	19.3	17.3	21.3	**-5**	**0**	**0**	**-1**
Unweighted av	*9.4*	*0.2*							*-2*	*2*	*1*	*0*
Weighted av[3]	***9.0***	***0.3***							***-1***	***2***	***1***	***0***

[1] Standardised unemployment (%), & HICPs (%yoy)
[2] Absolute CPI deviation from 1.8% (+) added to u rate deviation from 5-yr av (+/-)
[3] Using adjusted GDP weights.
Source: Federated Hermes, based on Eurostat data, & Federated Hermes/consensus projections (p)

Chart 11. Divergence between the periphery & core had been correcting

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



Source: Federated Hermes, based on Eurostat data, & Federated Hermes/consensus projections (p)

United Kingdom

With a fifth of real GDP lost in Q2, (the biggest hit since 1709), personal consumption back to 2002 levels, policy rates already on the floor, and unemployment and Brexit headwinds to come, it will be a big ask securing the 'V'-shape recovery the BoE and others crave. This will keep the onus on fiscal expansion.

Chancellor Sunak's response to the crisis has been spirited, and he was right to do more in July, given the phasing out of furloughing by October, and doubts about how spendthrift returning workers can be. The VAT and stamp duty cuts are visible but temporary, and it remains to be seen whether they're a useful 'sticking plaster', or will help launch our pent-up demand during lockdown into something more lasting. We suspect the former, with another fiscal 'jump-start' probably needed in the autumn. This, together with the annual Spending Review, would then be the fourth Budget of 2020, offering him chance to focus more squarely on 'Green' ways to promote growth.

Negative rates might be a 'red herring'…

The legacy, of course, will be net debt build-up. Most visibly, the OBR estimate that extension of the furloughing scheme from July to October, even with contributions from firms, could take job-retention costs from £63bn to £84bn (3.9% of GDP). Taking all measures together, the budget deficit now balloons to about £370bn in 2020/21. At over 15% of GDP, it's easily a post-War high, and dwarfs the 2.4% that was expected in March.

This makes the UK government net debt-to-GDP ratio three times Japan's when Japan entered its 'lost decade' in the mid-1990s (chart 5). The UK's debt, at 100% of GDP, is its highest ratio since 1963. In 2019, it was 80%. Unless growth takes off, we would, by 2030, approach our 250% post-war high if debt continues accumulating around this pace. An advantage this time, of course, is no longer having foreign-currency debt that contributed to our having to borrow from the IMF in 1976. This time, the debt is all in sterling with the printing press running. A relaxed approach would thus be akin to that of paying off the UK's War Loans, to the US and Canada, only in 2006.

But, not to crowd-out growth, QE may be harder to kick. Which lays down at least three challenges to BoE Governor, Bailey: of fanning demand-led inflation, trying to ease the distortions from QE, and, given increasing QE and the PM's 'policy-grab', protecting *"…all the time"* BoE independence (Bailey, August 2019). To smooth market distortions, the Bank's expansion in April of the Treasury's 'Ways and Means' facility was a logical step, as it was in 2008. But, telling would be if it's extended indefinitely, for markets, blurring the distinction between the BoE and Treasury as gilt supply escalates.

The MPC will be wary of 'squandering' its ammunition, preferring initially to use QE, rather than visibly taking Bank rate into negative territory. But the negative-rate dilemma might be a 'red herring'. Using the BoE's 2009 simulations, we calculate the BoE is running a true policy rate as low as -6%, or -7% in real terms, when QE is fully taken into account (chart 12). Together with other measures, this confirms by far the loosest monetary-and-fiscal stance in 30 years of data, probably post-War, with little correction in 2021. It thus questions the urgency in following the BoJ and ECB onto negative official rates, given we've in effect been running them for a decade.

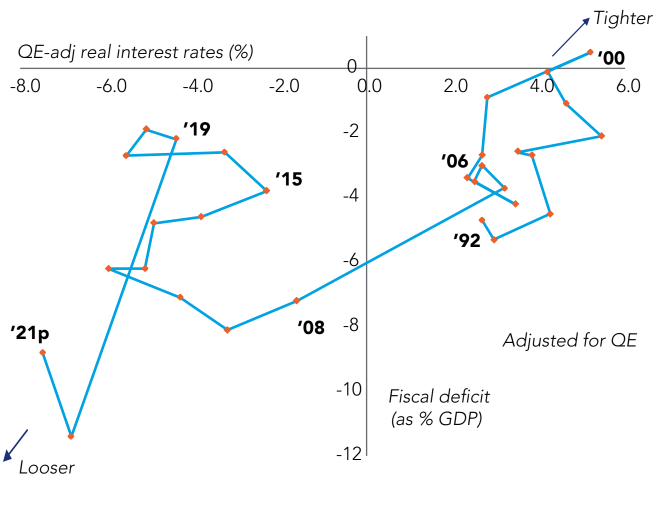
And, even once the virus dissipates, the MPC should fall easily short of its 'Goldilocks' Bank rate of 2%. This equilibrium rate (r*), defined as that needed to deliver trend growth and anchor CPI to its +2%yoy target, is hoped in the longer-term to rise to 2-3%, as better productivity spurs wages and 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 or more (chart 13).

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 2008/09, delivering the UK's own 'lost decade' – begins to lift, justifying higher wage claims. With furloughing ending, however, it seems unlikely that current wage *deflation* will be reversed by a productivity bounce that is helpfully driven by output, rather than unemployment.

Then there's Brexit, with clarity needed on whether a trade deal can stave off WTO-terms tariffs. Our suspicion remains that the process may take years to ultimately secure a 'satellite' alignment with the EU (e.g. Norway) and/or part-access to the Customs Union (Turkey) or Single Market (Canada). And, even if a deal can be fast-tracked, it would likely be a precursor to sorting out the various legal, trade, and regulatory systems that extends beyond 2020.

Chart 12. The UK's macro policy-mix with emergency measures

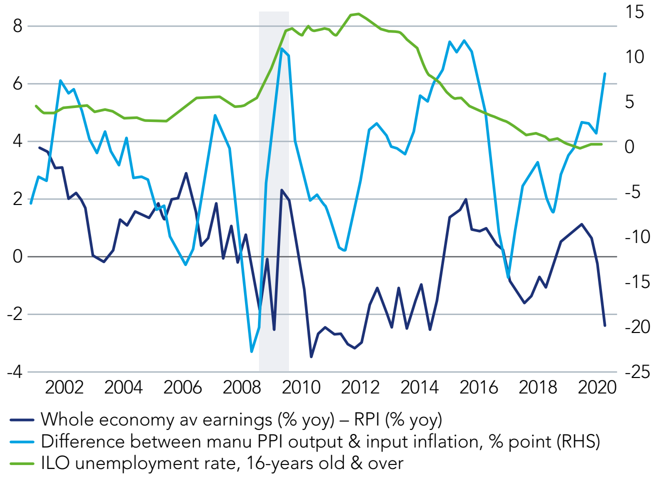
Using QE-adjusted Bank rate, CPI, & cyclically-adjusted fiscal balance as % GDP. Unch rates in 2021



Source: Federated Hermes, based on OBR, OECD, & Bloomberg data

Chart 13. Extending a decade of sub-par wage growth?

UK unemployment rate (%), vs profit margins, & real earnings growth (%)



Source: Refinitiv Datastream, based on ONS data

China

While remaining vigilant to any second wave from the virus, the focus will remain on supporting the domestic economy, repairing China's image as a responsible global power, and compensating for the ill-winds of beggar-thy-neighbour policies.

The virus provided a hit to H1 activity that the authorities have been loath to acknowledge. Q1's -6.8%yoy GDP – the first fall since 1976's ending of The Cultural Revolution – echoed private estimates, in a year when GDP-growth of at least 5.5%yoy was needed to double 2010's GDP level and *per capita* income. A core aim since 2015, its deferral was confirmed by May's omission for the first time of an explicit annual GDP-target. Admittedly, some of Q1's GDP drop has been clawed back, by Q2's +3.2%yoy. But, based on the NPC's +5.4%yoy *nominal* GDP and +3.5% CPI assumptions, this infers just 2%yoy real growth in 2020, versus an 8.8%yoy average since 2000 (chart 14).

Just 2% real GDP-growth inferred for 2020…

Pro-growth officials still support a sizeable shift from the supply-side reforms of 2016-2017. Yet, key pro-reformers, such as President's Xi's Economic Adviser, Liu, are *so far* limiting the spending stimulus to 3.6% of GDP. Officials believing China is ahead in the pandemic cycle are also wary of repeating 2008's 13%-of GDP (CNY 4trn) 'shock and awe' stimulus, which raised overcapacity and leveraging. Xi's strengthened hand (he is now entrenched beyond 2022) does allow him to address the risks flagged at annual Central Economic Work Conferences, of limiting asset bubbles, taming debt, and managing shadow banking. But, with the economy slowing even pre-virus, as 2017's credit tightening and 2018-19's trade-restrictions fed through, bolstering GDP is important.

Onus will thus remain on China's traditional levers for getting growth back on track, including agricultural subsidies and bringing forward infrastructure projects. To make sure, Q2's measures including direct transfers/subsidies, unemployment insurance, tax reliefs and breaks, as well as banks being 'required' to use their lower reserve-requirements to purchase government Special Treasury Bonds, will remain. Fortunately, with GDP averaging +6%yoy since 2015, there's little real political ignominy in recording further virus effects. Given the GDP foregone, though, this probably reduces the scope later for addressing the financial risks, and beefing up the renminbi.

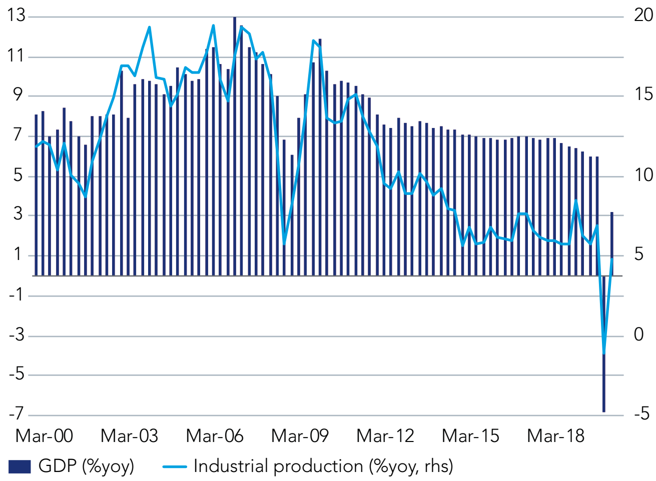
Yet, during trade tensions, the latter aim looks remote. The RMB has been allowed to fall fastest during bouts of global influence – such as rising US rate-expectations in Q4 2015, Brexit fears in Q2 2016, higher, Trump-inspired US inflation expectations in Q4 2016, and the virus-spread in H1 2020. This, plus growing protectionism as China's bilateral surplus with the US remains bloated (chart 15) suggest further RMB downside.

Either way, economic harm to China and the US looks inevitable. Politically, the virus has increased scope for 2019's 'Phase I' US trade deal to break down and lessened the prospect of a Phase II deal on industrial policy. China's concessions on IP and pledge to double US goods-purchases come as it is slowing. And, should trade tensions escalate, the PBoC will weaken the renminbi, but only reluctantly, given the risks of imploding China's corporate and banks' balance sheets most exposed to USD debt.

Yet, if he can blame it on the US, renminbi depreciation – as well as lower reserves, selective defaults, and a lower growth-target – may all be easier for Xi to present into the twentieth National Congress in 2022. In which case, non-deliverable forwards implying an 8-9% USD/RMB fall four-years out (that is, over the next US Presidential term) may be complacent!

Chart 14. China can use traditional levers to pull growth back up…

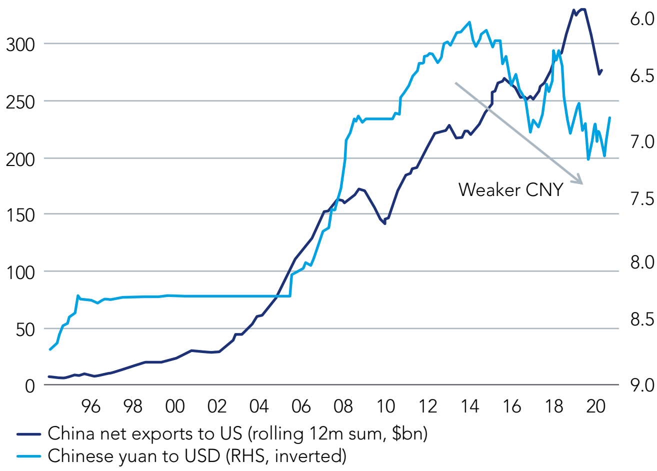
GDP & industrial production growth (both %yoy); end-quarter data



Source: National Bureau of Statistics data

Chart 15. But, PBoC would 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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