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Economic outlook

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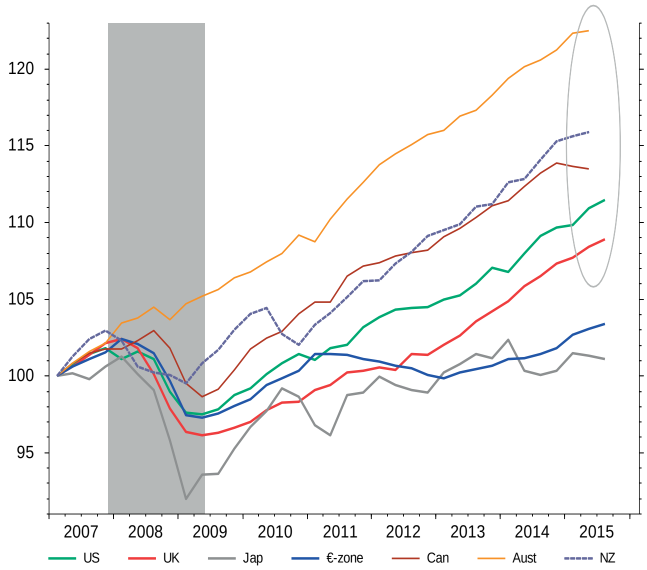
Looking into 2016…

Main points

- Despite China's slowdown, concerns about Greece, & imminence of the US Fed's first rate hike, global growth should not be completely derailed. But, clearly, these are headwinds, & another reason for central banks to take only baby steps to normalising rates.
- With the gap in 2015 between advanced and emerging economies' growth rates, at just 2%yoy, the smallest since the dot.com boom of 2000, the pressure to preserve world growth is tilting back from the emerging to advanced economies.
- Our macro outlook is based on four core beliefs. First, not only will US and UK real policy rates stay negative into 2017, but 'peak' rates when they come will be much lower than we're used to, & certainly below the US/UK's historic averages of about 5%.
- Second, these peak rates will ultimately be delivered by central banks running down their assets via 'QT' (quantitative tightening). The BoE wants first to see Bank rate back up around 2%, which will take years. This could be part of a 'disaster recovery' for Brexit (risk case), which may need extra QE.
- Third, China may be slowing, but has the wherewithal to soften the landing. Even with just 3% real growth in 2015, China will have generated over two years nominal growth equivalent to the total GDP of Spain. Expecting it to carry on doing more was unrealistic.
- Fourth, despite pockets of vulnerability, a 'blanket' emerging market crisis seems unlikely. External debt ratios are generally lower, there are fewer fixed pegs to protect, & they can print money. This makes comparisons with 1994, when most assets were hit hard, look superficial.
- Meanwhile, the 'baton' looks like it's being handed back to the advanced economies to fuel world growth, while China enacts an avalanche of stimulus measures sufficient to arrest the decline and avert market turmoil.
- If it doesn't, the US Fed's rate tightening cycle could prove to be one of the shortest yet. Which all suggest 2016 will be more like 2015 than 1994. The ball is admittedly in China's court - but doing nothing would be a bit like a turkey voting for Christmas…

Chart 1. Advanced economies are following a two-speed recovery…

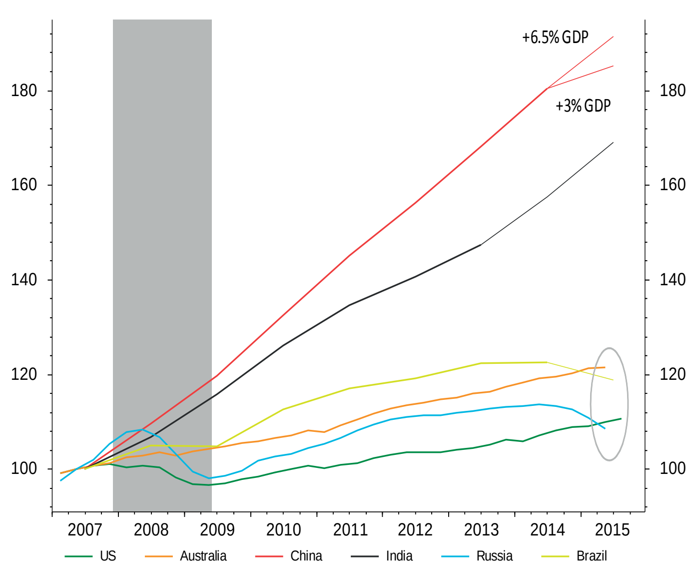
Real GDP levels, re-based to Q1 2007 (=100). Grey denotes US recession



Source: Thomson Reuters Datastream, based on national data

Chart 2. …While China (& other BRICs) slow, but from a very high base

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



Source: Thomson Reuters Datastream, & Hermes projections (faint lines)

Comment

Despite the China-inspired plunge in equities, concerns about Greece, and imminence of the US Fed's first rate hike, global growth should not be completely derailed. But, clearly, these are headwinds, as evidenced by the IMF's latest 0.2%point down-revisions to its world growth projections. After 3.4%yoy growth in 2014, it now expects 3.1% in 2015, and only a shallow uplift to 3.8%yoy by 2017 *(chart 3)*. This 3.1% stands to be the lowest since 2009, when China was officially growing 9%yoy. And, with the gap in 2015 between advanced and emerging economies' growth rates, at 2%yoy, set to be the smallest since the dot.com boom in 2000, the pressure to preserve world growth may tilt back from the emerging to advanced economies.

Handing over the growth 'baton'...

Yet China's slowdown - even to more realistic 3% growth - starts from a relatively high base. *Charts 1* and *2* put China's likely slowing in *real* growth in 2015 into perspective. This is under both official, *"close to 7%"* and weaker, 3% growth scenarios. Using the appropriate deflators, China's *nominal* growth since 2013 has been huge. **Even with just 3% real growth in 2015, China will have generated extra nominal GDP, at $1.3trn, equivalent to around the total GDP of Spain, or twice Switzerland's. Delivering 6½% real growth over two years would, at $1.7trn, have generated the equivalent total GDP of Canada!**

Expecting China to consistently generate the GDP of a G7 economy was unrealistic, so markets and central banks have been right, albeit belatedly, to reassess. Expect only baby steps toward policy exits, as central banks with 'skin in the game' avoid taking us off-guard. **Our macro outlook is based on four core beliefs.**

First, not only will US and UK real policy rates stay negative into 2017, but 'peak' rates will be much lower than we're used to. Eight years after the first traces of crisis, and we have a two-speed recovery ***(chart 1)***. In the lead are the US, UK, Canada, Australia and NZ. But, in the slow lane, Japan and the euro-zone are barely back to 'square one'. The euro-zone will continue lacking fiscal union ***(page 5)***. Greece may have to restructure, but this should be felt by official institutions rather than markets. The ECB, like the BoJ ***(page 4)***, will extend liquidity.

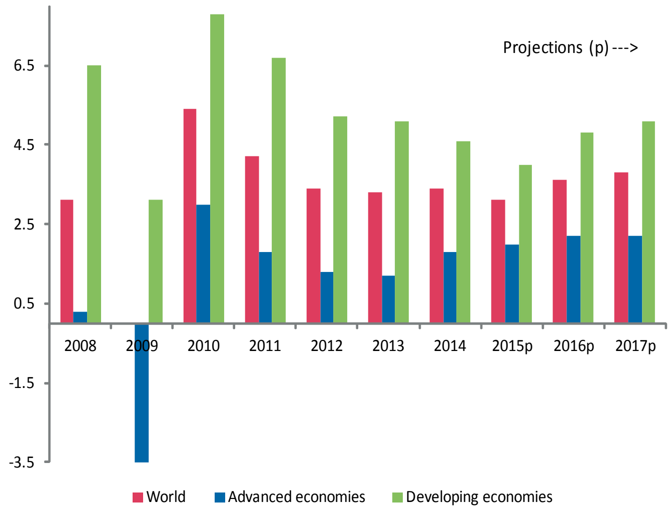
Renminbi devaluations are a further warning to the US Fed that, if they continue to push up the US$, the deflationary kick-back via weaker EM currencies will be greater than hoped. This offers an external incentive for the Fed to start only a slow, shallow and (given China's large US Treasury holdings) well-telegraphed tightening path ***(page 3)***.

Second, ultimately, low peak rates will be delivered by central banks running down their assets via 'QT' (quantitative tightening). We expect long-term *maxima* of 3.75% in the US and 2¼% in the UK**.** The sequencing the US Fed and BoE have in mind is: start normalising policy rates to provide a buffer; stop re-investing the maturing QE-bought bonds; before ultimately selling back some of the QE stock.

The BoE wants first to strike a 2% Bank rate. This makes its QT unlikely before 2018, but gives reassurance longer-term that policy rates can stay below US/UK historic averages of 5%. **Meantime, oil prices may be struggling to recover amid plentiful supply, but will need to decline significantly to prevent headline inflation recoveries in 2016 *(chart 7)***.

One complication is the UK's march to a possible EU referendum by the end of 2017. Avoiding local then European elections points to H2 2016. Logic suggests the unlikelihood of the UK wanting to risk weaker ties with its main trading partner, FDI forgone, and a diluted relationship with the US. But, while the uncertainty may take the shine off the pound, dealing with a 'Brexit' may need the BoE to reactivate QE. At the very least, it would defer its QT even further ***(page 6)***.

Chart 3. World growth - onus tilting back to the advanced economies
Real GDP growth, & consensus (advanced/developing), & IMF (world) projections



Source: Bloomberg, based on national data, & consensus/IMF projections

Third, China may be slowing, but has the wherewithal to soften the landing *(page 7)*. The leverage and deflation effects need watching. But, real lending rates and banks' reserve requirements can be cut, with further renminbi devaluations, direct lending, and a range of fiscal stimuli. For enterprises, real lending rates are as high as 12%. Should *domestic* debt strains build, China could run QE. More troublesome might be the up to $1trn of corporate and bank *foreign-currency* debt. **But, the PBoC would surely delve into its massive $3½trn foreign exchange reserves to avoid something more systemic.**

Fourth, a 'blanket' emerging market crisis seems unlikely. For some, the 'triple whammy' of China devaluation, US rate hike, and European weakness will revive memories of 1994 when most assets were hit hard. But, that was a different time. China's devaluation was huge, based more on reform than growth, and pressured Asian sovereigns to whittle away reserves to protect their own currency pegs. The only meaningful peg now is Hong Kong's, which should benefit from a weaker renminbi, given half its imports are from the Mainland.

In 1994, US growth was centred on 4½%yoy, with a small output gap, and CPI expected at +2½-3%yoy. This caused the Fed to worry about 'overheating'. Now, central banks have too much 'skin in the game' to take us off guard, with the Fed running $3trn excess reserves.

Pockets of vulnerability exist, of course, such as those sovereigns with high exposure to short-term US$ debt and foreign saving needs. These include Latam, Ukraine, S. Africa, Turkey. But, others have used previous crises to get their houses in order, with external debt ratios lower. And, where domestic debt ratios climbed because of fiscal expansion and/or political risk, their central banks can print money.

Meanwhile, the 'baton' looks like it's being handed back to the advanced economies to fuel world growth. This means accelerating QE in Japan, the euro-zone and Sweden, rate cuts in others (Australia, NZ, Norway) and competitive currency falls, while China enacts an avalanche of stimulus measures sufficient to arrest the decline and avert market turmoil. **If it doesn't, the Fed's rate tightening cycle could prove to be one of the shortest yet. Which all suggest 2016 will be more like 2015 than 1994. But, the ball is in China's court.**

United States

The Fed looks braced for its first policy rate hike since June 2006. Inflation is low, but with the labour market picking up and the FOMC's language incrementally more hawkish, the first, 25bp move should come with announcement of its new economic forecast on 16 December. Our projections show CPI inflation settling back above 1%yoy in the New Year, *en route* to the Fed's 2% comfort level in late summer 2016. A slow tightening will allow time to assess the ripple-effects from China. And, given market sensitivities, subsequent moves should be well telegraphed, 'sugar coated' by reassurances that 'normalisation' will be data dependent.

The -5% funds rate is far too loose for an economy seven years out of recession...

On the basis of the US's relative insulation from global economic headwinds, the fall of unemployment into the Fed's 5¼-5½% Nairu range, and our upbeat outlook, rate hikes should extend through 2016. **The second-round effects need watching, but only 1% and 3% of US GDP respectively come directly from China and euro-zone demand.** Our expectation of a 1.25% funds rate for the end of 2016 lies close to the FOMC's median assumption of 1.4%. This suggests another 12 months of a negative real funds rate - on top of the five years (barring H1 2015's oil deflation) we've had. **Further out, our projected maximum 'peak rate' of 3.75% compares with the FOMC's 3.5%.**

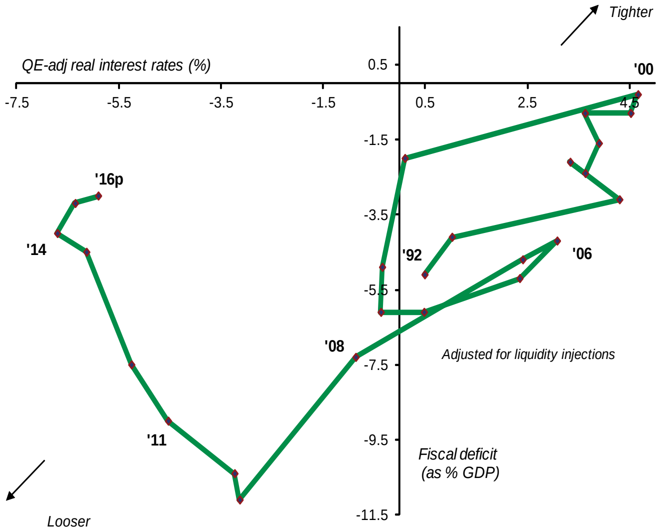
But, the official funds rate has been distorted by QE. By taking account of 2009-14's QE and the fiscal position, our *Policy Looseness Analysis* beefs up the 'Taylor Rule' the Fed uses for setting rates. The Taylor Rule (without QE and fiscal considerations) currently pitches the appropriate Fed's target rate at 3.8%: 350bp above its current range.

We quantify the trade-off by adjusting real rates for Bernanke's assertion that $600bn of QE2 in 2011 was akin to slicing 75bp off the Fed funds target. Extending this to the total $4.4trn QE infers about 550bp in total easing, leading to a *de facto* (QE-adjusted) funds rate of about -5%. This is much lower than the 0.25% official rate. Running a true rate this low is making some FOMC members uncomfortable.

On this basis, ***chart 4*** shows how US policy is evolving. It points to only a modest tightening of overall conditions in 2016, helped by the fiscal side. Monetary policy - even under our assumption of up to four 25bp rate hikes by the end of 2016 - will remain relatively accommodative. This makes 2016 the eighth year running of ultra loose conditions.

Chart 4. This is how the US's macro stance is shifting, adjusted for QE

Using QE-adj 3m money rates, core PCE, & cyc-adj fiscal balance as a % of GDP



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

Meantime, the FOMC's dual mandate will keep it fixated on key macro and financial data. First, a jobs recovery that has been disappointingly slow. The unemployment rate has since 2009 taken two-three years longer to fall to comparable levels of previous recoveries. Payroll gains have been muted, and even now are rising at a run-rate (three month average) of barely 200,000 per month. But, wage pressure should soon build. The falling unemployment rate reflects not just job gains, but a drop in the 'participation rate', which has plummeted to a 36-year low. Its drop is the mirror image of the UK's rise since 2012.

For some FOMC 'hawks', three quarters of the US's fall reflects retirees, and take-up of allowances after a relaxation of the rules. On the premise they are in general unlikely to re-enter the workforce, this should support wage growth. And, especially given what seem increasingly like hiring difficulties/skills shortages. The ratio of job hires-to-openings is falling at a time when productivity is improving.

The main financial distractions for the FOMC will remain stock markets and house prices, which have been rising in real terms for over four years. As pillars of the private-sector led recovery, any sudden jolt to either would be an unintended consequence of normalising. The Fed is especially mindful that average 30-year mortgage rates leapt after Bernanke's 'taper-gate' warning in May 2013. His 'cold feet' thereafter, and Yellen's 'no change' in September, then apparent 'flip-flop' on China, reflect FOMC caution even at this stage of recovery.

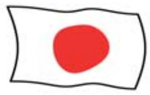
Helpfully, also, there's less urgency for fiscal correction. While, growth-induced tax revenue has helped bring down the budget deficit from 10% of GDP in 2009 to a likely 2.6% in 2015, the $18.1trn debt ceiling has been extended out to March 2017. Not only does this avoid repeating the government shutdown of August 2011, it reduces political obfuscation in election year. The falling deficit has made it easier for the Democrats to act, while fiscally-obstructive Republicans will not have wanted to hand them the 2016 election, in the way they 'contributed' to Clinton's re-election in 1996.

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

% yoy unless stated	'10	'11	'12	'13	'14	'15e	'16p
Real GDP	2.5	1.6	2.2	1.5	2.4	2.4	2.6
Personal consumption	2.0	2.3	1.5	1.7	2.7	3.0	2.8
Business investment	2.5	7.7	9.0	3.0	6.2	3.6	5.2
Industrial production	5.6	3.0	2.8	1.9	3.7	2.0	2.5
Consumer prices (nsa)	1.6	3.2	2.1	1.5	1.6	0.2	1.7
Unemployment rate (%)	9.6	8.9	8.1	7.4	6.2	5.3	4.8
Current account (% GDP)	-3.0	-3.0	-2.8	-2.3	-2.3	-2.5	-2.6
Fed budget balance (% GDP)	-8.4	-7.9	-6.5	-3.3	-2.8	-2.6	-2.7
Funds target (yr-end, %)	0.25	0.25	0.25	0.25	0.25	0.50	1.25

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

Japan



PM Abe still has every incentive to accelerate his pro-growth policies. By sealing another two-thirds Lower House majority in December 2014, then extending his LDP presidency in September, his position looks secure out to 2018. Weak opposition from the DPJ also puts him in good stead to boost his LDP/Komeito coalition's 55% hold on the Upper House in July 2016. Doing so would strengthen his mandate for reform (including on nuclear power and defence), and allow him to test Koizumi's record, in 2001-06, of staying in office for five and half years. To maximise his chances, economic policies will remain centred on growth and an inflation rate that's lost momentum.

Abe's secured another three years, but has every incentive to accelerate growth...

Challenges remain. Despite a softer yen, GDP has been slow to rebound from the sharp 2%qoq drop in Q2 2014. This came after the first leg of the consumption-tax rise, from 5% to 8%. With demand having been front-end loaded, the authorities expected a recovery in Q3. But, by GDP falling 0.3%qoq then stuttering, Japan now lies in its fifth GDP-based recession since 2008. Encouragingly, it did rebound 1.1%qoq in Q1 2015. But, with inventories driving it, and consumption (on both the official measure and the Cabinet Office's synthetic, monthly reading) only now turning up, more stimulus is needed.

Little wonder the second leg of the tax rise, to 10% has been deferred 18 months to April 2017. An important consideration will have been falling land prices. This was the common denominator when the MoF previously raised the sales tax in 1997 (from 3% to 5%), and the BoJ in mid 2000 prematurely ended its zero rate policy. **Each time, they had to back-track as the economy slumped. Land prices have now been falling for most of the past 23 years.**

Mindful of 1997 especially, when demand failed to recover into the Asia crisis, the MoF has aimed an extra ¥3trn ($24bn) stimulus at the lower-income end and SMEs. **And, to add weight, the BoJ is likely to again accelerate its QE, after having raised in October 2014 its asset-purchases target from ¥70trn to ¥80trn *per annum.*** While helpful, this tax deferral, together with plans to cut the corporation tax from 35% to under 30%, dilute any fiscal consolidation as Japan's public-debt/GDP heads toward 240%. This is the developed world's highest.

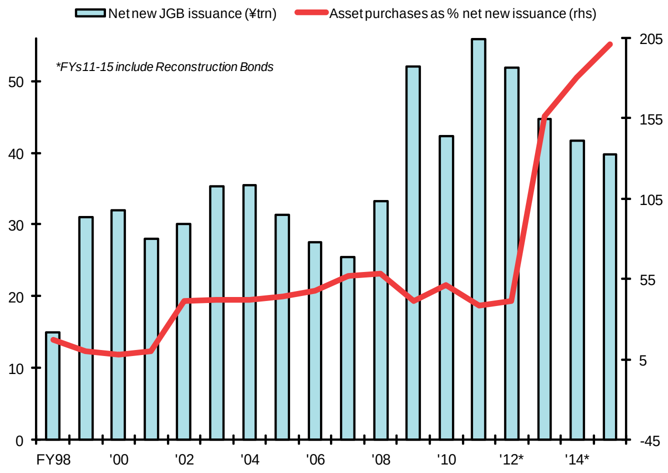
Economic & interest rate estimates (e) & projections (p)

% yoy unless stated	'10	'11	'12	'13	'14	'15e	'16p
Real GDP	4.8	-0.4	1.8	1.6	-0.1	0.8	1.3
Private consumption	2.8	0.3	2.3	2.1	-1.3	-0.6	1.5
Business investment	0.7	4.1	3.6	0.6	3.6	1.5	3.0
Industrial production	15.6	-2.6	0.2	-0.6	2.1	-0.5	1.8
Consumer prices	-0.7	-0.3	0.0	0.4	2.7	0.8	1.1
Unemployment rate (%)	5.1	4.6	4.3	4.0	3.6	3.4	3.3
Current account (% GDP)	4.0	2.2	1.0	0.8	0.5	2.8	2.3
Gen budget balance (% GDP)	-7.2	-7.9	-7.9	-7.8	-7.1	-6.5	-6.4
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 5. The BoJ has to mop up even more government bonds

Shows net new JGB issuance, & BoJ asset purchases as a % of net new issuance



Source: Hermes Investment Management, based on MoF, & BoJ

It postpones another near proportionate lift to the CPI, and its contribution to the ¥12½trn (2% of GDP) planned revenue lift from the two hikes. Without faster tax revenue, deferral thus threatens Abe's aim of a primary surplus by FY20, even with the Tokyo Olympics.

Wage growth is the other missing link. Inflation may be collapsing as the base-effect from the tax rise washes out, but consumers have yet to be compensated for the 5% *cumulative* price rise under Abe. Wages need to lift to avoid a repeat of 2008, when an oil-inspired CPI rise hurt consumption; otherwise, his progress will be another false dawn.

The 2015 spring wage-round *(shunto)* was tame. Full-time workers' base-awards rose 0.5%yoy in April 2015, unchanged from Q1's average. This was this flat in real terms, and no base-award improvement on 2014's *shunto*. **Our Phillips Curve analysis suggests that, if delivered, wage growth *would* knock-on to the CPI, given the unemployment fall since 2009.** BoJ research concurs, by identifying a negatively sloped curve, and a greater degree of long-term wage responsiveness in Japan than in the US (BoJ Working Paper, February 2014).

With fiscal policy constrained, this keeps the BoJ 'in play'. **At ¥80trn, the BoJ in FY15 (year ending March '16) will have mopped up JGBs at twice the pace of annual net supply *(chart 5)*.** More if the target is raised soon. This means, under governor Kuroda, its share of JGBs outstanding has doubled to 37% - above the US Fed's 25% of Treasuries, and the BoE's one-third share of conventional gilts.

And, unless growth picks up, pressure on the BoJ may come also from the Government Pension Investment Fund's reallocation to equities from bonds. At stake is a JGB re-weighting from 60% to 35% of assets, and an upgrading from 12% to 25% in domestic stocks. This is aimed at putting a floor under the Nikkei. Abe's goal, as part of his third arrow, is to reduce the portfolio's inflation hit from holding conventional JGBs, while raising its long-term (10-year) return.

But, it's doubtful the MoF can unload this amount of JGBs ($192bn) without raising funding costs. The BoJ will thus - throughout 'Abenomics' and beyond - be the backstop for bonds. Which is just as well, given progress on hitting its +2%yoy CPI target *"by March 2017"* will be assessed as Abe prepares for the Upper House election.

Euro-zone

Despite real GDP finally back up to its pre-crisis level and a core CPI over +1%yoy, the likelihood in 2016 of *headline* inflation staying below its 2%yoy target will keep the ECB loosening conditions. Headline inflation starts 2016 at around zero. And while some uplift may come from a stronger US$ (bloating the zone's euro-denominated import prices), China's slowdown and Asia's competing currency depreciations pose fresh deflation risk. The ECB - which in the absence of fiscal union, remains the zone's surrogate 'government' - cannot rely on the US Fed's gentle tightening path to do the work for it. So, with few options available, expect further forays into the ECB's unconventional policy measures of 2014 and 2015.

With the ECB as the surrogate 'government', expect further forays into the unconventional

Of these, attention will remain on amendments to the €1.1trn asset purchase programme, which was designed initially to run till September 2016. As in Japan, the US and UK before it, QE's ineffectiveness thus far in sparking inflation makes it likely Draghi will extend it if the path of inflation is not *"...consistent with achieving inflation rates...close to, 2% over the medium term"* (12 November).

With just over one-third of the €1.1trn having been completed by December, the size of the programme could be raised, the pace accelerated (from the initial €60bn per month) and *"Other instruments could also be activated...if necessary"*. In the first 11 months of QE, sovereign bonds have accounted for two-thirds of ECB purchases, the remainder being covered bonds (mostly), ABS, agencies, and utilities. Possibilities for broadening include corporate bonds and mortgages.

As an adjunct, further cuts in the already negative deposit rate look inevitable if the extra liquidity that QE provides is to transmit to the real economy. As the ECB's Bank Lending Survey reveals, credit availability close to a five-year high is not being matched by credit demand which continues to cool. Deposit-rate cuts are aimed at discouraging cash hoarding. But, their effectiveness has thus far been in keeping long yields down more than boosting loan demand.

The ECB commitment to buying government bonds down to a yield equivalent to the negative deposit rate looks the more convincing support to growth - given around two-thirds of euro-zone private borrowing (consumer and corporates) is long-yield driven.

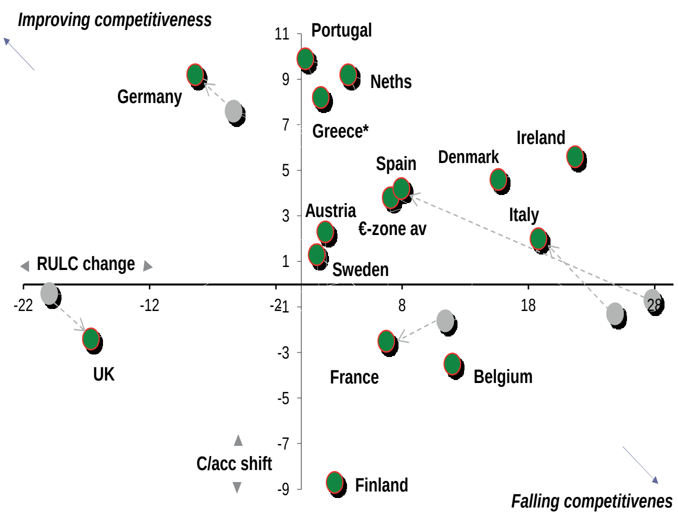
Economic & interest rate estimates (e) & projections (p)

% yoy unless stated	'10	'11	'12	'13	'14	'15e	'16p
Real GDP	2.0	1.7	-0.8	-0.3	0.9	1.5	1.6
Private consumption	0.8	0.0	-1.2	-0.6	0.9	1.7	1.6
Fixed investment	-0.6	1.8	-3.4	-2.6	1.3	1.4	2.3
Industrial production	7.3	3.5	-2.3	-0.7	0.8	1.6	2.2
Consumer prices (HICP)	1.6	2.7	2.5	1.3	0.4	0.1	1.2
Unemployment rate (%)	10.1	10.2	11.4	12.0	11.6	11.0	10.8
Current account (% GDP)	0.3	0.2	1.3	2.0	2.4	2.5	2.4
Gen budget balance (% GDP)	-6.2	-4.1	-3.7	-3.0	-2.6	-2.3	-2.0
ECB refi' rate (yr-end, %)	1.00	1.00	0.75	0.25	0.05	0.05	0.05

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

Chart 6. The zone remains a monetary union bereft of economic union

Change since 2000 in RULC, vs c/acc shift as % GDP. Grey denotes shift since 2010



Source: Hermes, based on national sources, & OECD data. *Greece is from 2001

In the event, though, these tools do little more than address the symptom: deflation. They cannot be expected to solve the underlying problem - a monetary union devoid of economic union, which will take years to solve.

Our *Competitiveness Analysis* in ***chart 6*** shows the progress so far. We use the OECD's estimates of a country's unit labour costs in tradeable goods, relative to its main trading partners'. A rising index indicates a real effective exchange rate appreciation and falling competitiveness. An index fall signifies a relative cost-cut and a competitiveness boost (see our *Euro-zone - pulling the trigger* report, January 2015).

As an *amorphous bloc*, the euro-zone has after four years of austerity started to regain competitiveness lost since the euro. Yet, shifts in *individual* members' competitiveness remain too disparate. The biggest winners still include Germany, which is helpful given it accounts for a third of euro-zone GDP. But, with China and Russia slowing (accounting for 8% of Germany's exports), even this is being tested. By contrast, other members have experienced a deterioration.

Yet, Spain and Italy's deterioration is correcting, and their shortfall versus Germany reducing. This is shown by the reducing cluster in ***chart 6***. We highlight the up-to-2010 period by the grey blobs, to show how members' positions have gained since austerity. The latest estimates in green thus suggest improvement. Outside the zone, the UK has outperformed by virtue of sterling's net 12% depreciation between 2000 and 2014 - a route cut off to euro-zone members

Then there's Greece, whose deflation has improved competitiveness, but exacerbated its real-debt dynamics. It may have secured its third, €86bn support package, but without debt relief, this looks more a 'sticking plaster' than a *panacea*. Greece faces another €8bn in bond redemptions due to the ECB/IMF in the year ahead, and, after losing 22% of its real GDP since 2010, doubtless has reform fatigue.

A Greece debt restructuring in 2016 thus seems inevitable - though, encouragingly, with 80% of Greece's liabilities held by the IMF/ECB, the fall-out for private markets should be contained. Either way, the ECB stands ready to act.

United Kingdom

While the BoE's more cautious economic forecast is a 'catch-up' after China and the *"down-draught"* from emerging markets (EMs), it provides reason to defer both the first rate hike and a supplementary tightening via QT. The Bank's November assessment incorporates the China effects its August forecast omitted, with the GDP growth outlook shaved down 0.1-0.2%point to 2017. But, while the drag from EMs prevents a quick erosion of the 'output gap', domestic demand is expected to stay *"resilient"*. We concur, and expect GDP growth to stay centered on 2½%yoy through to 2017 - above the 2% 'potential' rate the OECD believes is necessary to stave off deflation.

Linking QT to a 2% Bank rate could be part of a 'disaster-recovery strategy' for Brexit...

Below-target inflation, though, will remain the most visible reason for keeping Bank rate unchanged, with the BoE's single, CPI mandate offering little automaticity that the MPC will rush to follow suit once the US Fed moves. By extending their sub-target CPI period into 2017, there is little urgency, especially with the number of scheduled MPC meetings shortened in 2016 from 12 to eight. Yet, our projections ***(chart 7)*** point to a gradual CPI uplift in 2016, as oil's base-effect washes out. **Our expectation of a 2%yoy CPI in Q4 2016 suggests the proactive MPC working to a two-year horizon could hike around its August meeting. This is nine months after the US Fed's likely first move.**

One complication may be the EU referendum by the end of 2017. With a four-months notice period required, avoiding local elections in May 2016, then France and Germany's preoccupation with their general elections in May/October 2017, suggest (if called) a possible Q4 2016 referendum. Logic suggests the unlikelihood of the UK wanting to risk weaker ties with its main trading partner (46% of export value, 53% of imports), FDI forgone, and a diluted relationship with the US. But, the uncertainty could at some stage erode the UK's safe-haven status, taking the shine off equities and the pound.

In the event of 'Brexit' (our risk case), short-term conventional gilts may benefit initially from the perceived hit to growth. But, this could be short lived, given about one third of the £1.3trn total gilts outstanding is backed by international investors sensitive to currency and ratings risk. **In which case, it's possible that dealing with a Brexit and a hit to growth may need the BoE to again be the biggest sponsor of gilts,**

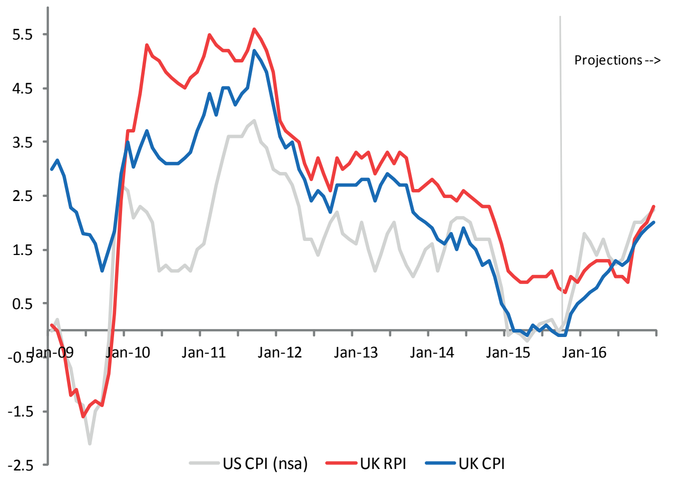
Economic & interest rate estimates (e) & projections (p)

% yoy unless stated	'10	'11	'12	'13	'14	'15e	'16p
Real GDP	1.5	2.0	1.2	2.2	2.9	2.5	2.4
Household consumption	0.1	-0.1	2.0	1.9	2.7	3.0	2.5
Fixed investment	6.2	2.0	1.5	2.6	7.5	5.0	5.5
Manufacturing production	4.7	1.8	-1.3	-0.7	3.2	0.5	1.5
Retail prices index	4.6	5.2	3.2	3.1	2.4	1.0	1.4
Consumer prices	3.3	4.5	2.8	2.6	1.5	0.1	1.3
Unemp, ILO rate (3m av, %)	7.9	8.1	8.0	7.6	6.2	5.4	5.2
Current account (% GDP)	-2.8	-1.7	-3.3	-4.5	-5.1	-4.6	-4.6
Gen budget balance (% GDP)	-10.1	-7.9	-5.1	-5.6	-5.2	-3.9	-2.5
BoE Bank rate (yr-end, %)	0.50	0.50	0.50	0.50	0.50	0.50	1.00

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

Chart 7. UK (& US) inflation should show some uplift in 2016

Shows our UK/US inflation projections (all %yoy), based on current Brent/WTI oil prices



Source: Hermes Investment Management, based on ONS, & BLS data

via QE. Even if rates had been raised by then (we expect a maximum 50bp in 2016), it's doubtful they could then be reversed, given the need to support sterling. QT would have to be deferred. Which leaves Carney's latest clarification - that the QE stock will be maintained around the current £375bn until Bank rate is about 2% - looking like a way of extending his policy options in case Brexit does occur.

When Carney does move, rate hikes will be only gradual and ultimately 'peak out' at a much lower level (we expect 2¼%) than the historic average of about 5%. This will *eventually* be helped by QT. Though, **on the basis of Carney's remarks, our rate projections, and the gilts redemptions profile, QT seems unlikely before 2018.**

For the longer-term, though, we quantify QT by using the Bank's estimate that £200bn in QE in 2009 was akin to taking 150bp off the Bank rate. Extrapolating, the cumulative £375bn QE implies a current policy rate of -2%. Assuming this is symmetrical, an around £130bn erosion of QE would be needed after 2018 to bridge the gap between a low 2¼% peak rate and a possible 'neutral' rate by then of about 3¼%.

Then there's the underlying fiscal tightening, reinforced by November's Autumn Statement. Despite nuances in his aim of plugging an annual £20bn spending slippage and a net fiscal loosening (relative to plans) of 0.2%point from here, the fiscal screw will have to stay tight if the underlying deficit is to be returned to the black in 2019/20. Even including special items like the transfer of the Royal Mail Pension Plan, QE profits, and bank sales, the near 4%-of-GDP deficit for 2015/16 could still be the G7's widest after Japan.

And, only last year is the net-debt-to-GDP ratio expected to have peaked, at 83%. This is more than twice Japan's in the mid 1990s when it limped into a 'lost decade'. The difference is that while Japan's debt has been sponsored (95%) by a relatively risk-averse, domestic investor base borrowing in a currency unhindered by foreign-saving needs (external surplus), the UK's position (external deficit) may prove more troublesome, if, for example, Brexit strikes.

But, meantime, below-target inflation, the cold winds from China, and an unfixed euro-zone should all keep the MPC 'sitting on its hands' - with little obvious reason to quickly follow the US Fed.

China

Encouragingly, the relative calm restored to China's foreign exchange and money markets after August's 3% renminbi devaluation suggests systemic risk is thus far being contained. Overnight Shibor remains centred on just 1.85%. But, risks remain. If the usual lags hold, the deceleration in money-growth engineered by The People's Bank of China (PBoC) after 2010 suggests another nine months before China's 'coincident indicator' (used to detect turning points) picks up.

China can soften the landing. But, it must act

This deceleration was to counteract the huge, 8%-of-GDP fiscal loosening in 2009 and the disproportionate growth in property and shadow banking sectors. Barring a labour shake-out, this will only hinder the productivity slide, deterring wage growth. Without sustained wage growth, which the NBS cites as a meaty 11%yoy in 2014 for urban areas, a re-balancing to consumption looks unlikely.

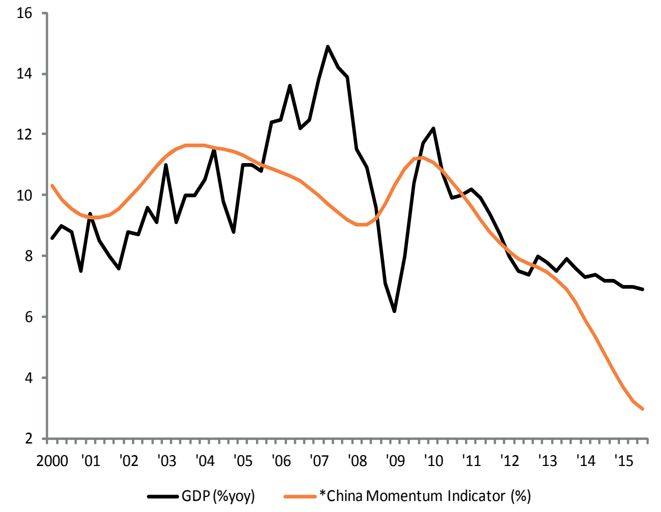
Official data for H1 2015 point to strong 12%yoy productivity growth. But, we estimate that, after double-digit rises in 2000-11, China's productivity froze in 2012-13, and fell about 7% in 2014. Official data suggest only a 3% fall. Worryingly, the latest up-tick, in Q4 2014 (based on the latest employment data), reflects job cuts more than output growth. This contravenes one of the Communist Party's primary economic goals, of maximising growth and employment.

And especially when alternative measures suggest official growth is overstated. Suspicion understandably falls on China's speedy compilation of GDP data: the G8's fastest. Released within three weeks of the pertaining quarter, they are barely revised, and consistently close to target. For 2015, the target is *"close to 7%"*, with Premier Li inferring a minimum +6½% *per annum* needed to 2020.

Alternatives such as the proxy mapped in *chart 8* identify a far lower effective growth rate. Compiled using second-tier activity data, including China's railway freight volumes, electricity production, and nominal bank-loan growth, suggest a dislocation since 2012 from the official growth target to a 'true' rate closer to 3%yoy. This may underplay services, but August's devaluation and PBoC rate cuts since confirm China is slowing. Two unknowns now are: the extent to which

Chart 8. China's official GDP versus its 'compiled' growth rate

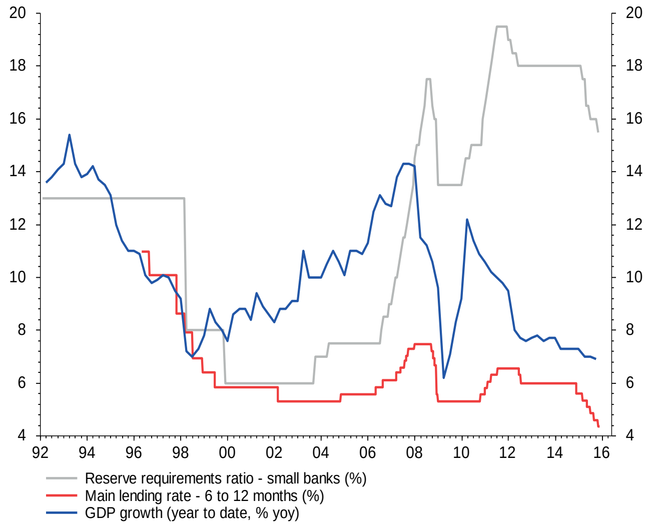
GDP (%yoy), & compiled activity indicator (%yoy, quarter averages)



Source: National Bureau of Statistics, & *Fathom Consulting China Momentum Indicator

Chart 9. But, China has plenty of scope to loosen monetary policy

Key lending rate & RRR (both %), vs GDP growth (%yoy). End-month data



Source: Thomson Reuters Datastream, based on NBS, & PBoC data

leverage behind China's equity positions dents activity, possibly via real estate; and the deflationary flow - via falling commodity prices, lower Asian exchange rates, and cheaper exports – to the G7. **Yet, while wary of the risks, we take comfort that China still has an array of policy 'buttons' to press to soften the landing. But, it must act.**

First, on the monetary front, real lending rates of 3% and 15½%-18% reserve requirement ratios (RRR) for banks are still punitive, and can be cut more aggressively ***(chart 9)*. Given half the economy is fixed investment, the *de facto* real rate is even higher. Enterprises face a real borrowing rate of 12%, when based on producer rather than consumer prices. Producer prices, at -5.9%yoy, have been deflating for nearly four years.** When rate changes come in tandem with RRR adjustments, such as the hikes in 2010-12, they impact China's activity.

Second, with August-September's $137bn reserve outflow unsustainable, further devaluations will be used as a pressure release. Non-deliverable forwards suggest -6½% over two years, which may be modest ahead of SDR inclusion from October 2016. Further intervention could raise questions about China's commitment to US Treasuries, so a one-off devaluation may be preferred to a 'drip-feed'.

Then there's fiscal policy. With the 2014 budget deficit officially reported at just 1.8% of GDP (which would make it the G8's third lowest), there's ample scope for largesse. Expect more stimuli ranging from agricultural subsidies and infrastructure spending (each traditionally used to hit growth targets), direct lending to preferred sectors such as agriculture and SMEs, and *ad hoc* liquidity injections.

And, should *domestic* debt strains build, China could run QE. More troublesome might be dealing with what could be up to $1trn of corporate and bank *foreign-currency* debt. Isolated defaults are possible. But, the PBoC would surely delve into its still massive $3½trn *foreign exchange* reserves to avoid something more systemic.

China thus has the wherewithal to avoid recession. Which is just as well, given a true re-balancing is years down the line. And, compared to others (*e.g.* Greece, unable to devalue externally, boost fiscally, and help the banks), China's policy position looks less acute.

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