JSA Consultancy Services

ECONOMIC UPDATE FEBRUARY 2021

INFLATION

The prevailing view of economists is that inflation is dead. Really?

In January 2008, as the subprime crisis unfolded, Davos buzzed with confidence. This was well articulated by Fred Bergsten of the Peterson Institute for International Economics: “It is inconceivable — repeat, inconceivable — that they’ll be a world recession”. Most economists failed to predict the crash in Q3 of 2008. Most economists are again failing to predict that inflation in the World economy will rise over the next few years.

We must ask why.
Most forecasting models are based on Computable General Equilibrium (CGE) models.

CGE models are large, numerical, models which combine economic theory with real economic data to predict the impacts of policies or shocks in the economy.

CGE models fit economic data to a set of equations which aim to capture the structure of the economy and behavioural response of ‘agents’ (firms, households, government). This provides a framework to simulate policy changes and trace the impact on key economic variables, including income and expenditure flows.

The model assumes a starting point of equilibrium; then a variable is changed and the model produces a new equilibrium position. It says nothing about the path to the new equilibrium.

Their biggest flaw is: Monetary effects are not captured in the model as there is no market for money. This means the model does not have a detailed treatment of the financial sector. Consequently, the model is unable to capture the effects of taxes levied on savings or assets, such as capital gains tax, stamp duty, or inheritance tax.

As well as this, the model does not capture the fact that debt is money, and banks manufacture it, and it ignores wealth effects - in other words how we behave when the value of our house or equities change.

It is my view that using these models is largely wasted effort. They create a false sense of accuracy and the equations are always one economic cycle out of date.

They continue to exist because of professional inertia and the fact that current teaching still emphasises neo-classical economics. CGE came

into existence in the mid-seventies. I graduated in 1971 and, as I spent hours tapping data into rudimentary mechanical calculators, I remember thinking that econometrics was significantly flawed.

Let us look instead at a common sense approach, based on realistic assumptions of how we behave.

Inflation is a decline in the purchasing power of a currency. It is quantified by looking at the change in the average price level of a basket of selected goods.

The Retail Price Index (RPI) for December was up 1.2%. The Consumer Prices Index, including owner-occupier housing costs (CPIH), in November was up 0.6%.

The difference is primarily caused by arithmetic. The RPI works on a simple average; the CPIH works on a geometric mean. The difference is that the CPIH will always come in at, or below, RPI. It is therefore preferred by Government.

Then there is the GDP deflator - a complex index which includes a wider range of price changes, particularly in supply chains, rather than just at the retail end. It is used to calculate real GDP growth.

The following data is the simple average over the past 10 years for the UK: GDP deflator average annual growth rate – 2%
Average annual inflation rate (RPI) – 1.7%

The average return on the FT 100 share index over the same period was 7.2% (meaning that gross wealth has doubled for investors)

Average house price rose 4.6% per year (which means a house owner's wealth has increased by about 6%)

Average growth in employee earnings has been 2.6% The average growth in the money supply has been 4%

When choosing an inflation indicator, we are spoilt for choice, so which average prices matter most?

I look at what is called money transmission. When new money is created by the banking system, where does it enter the national flow of spending? Which prices reflect it first?

My research suggests, but does not prove, that new money hits equity prices first; then property prices; then the exchange rate (sterling weakens); then RPI; then, last of all, and with a lag of up to 3 years, wage growth.

Consumer Behaviour

WHERE ARE WE TODAY?
Six months ago, UK money supply rose to 10% and has been above this since then.

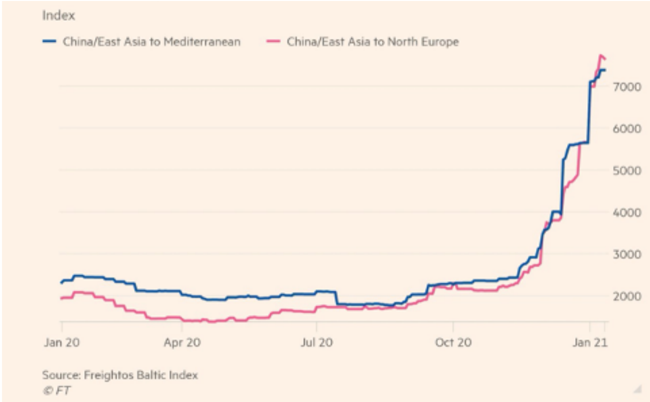
The FT all share index is up 10%; UK house prices were up 7.3% in December

RPI up 1.2%; CPIH up 0.6%

The GDP deflator is estimated to be 6.7% this year. This is not a typo.

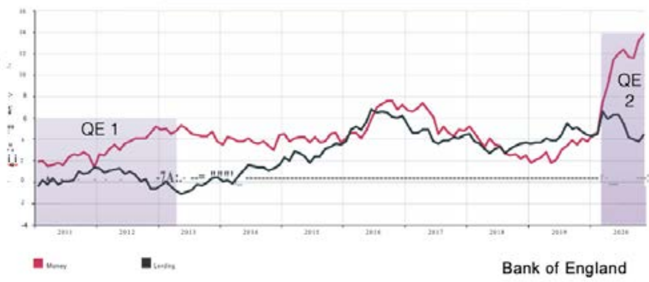
It reflects the expected change in post Brexit supply prices.

Container Freight Rates Have Soared

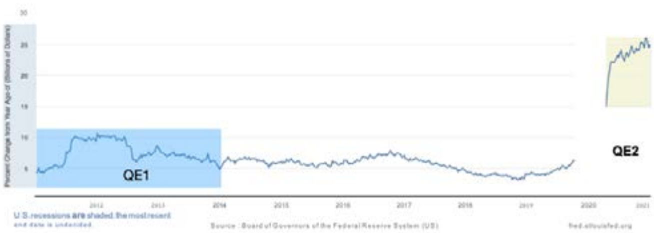


My main point is we already have inflation across a wide range of assets. And the global wall of money created by central banks - $17Tn over the past 9 months - will end up somewhere in the system. Thanks to Covid, there has been only a limited supply of goods, but an increase in purchasing power. Container freight rates are an excellent illustration.

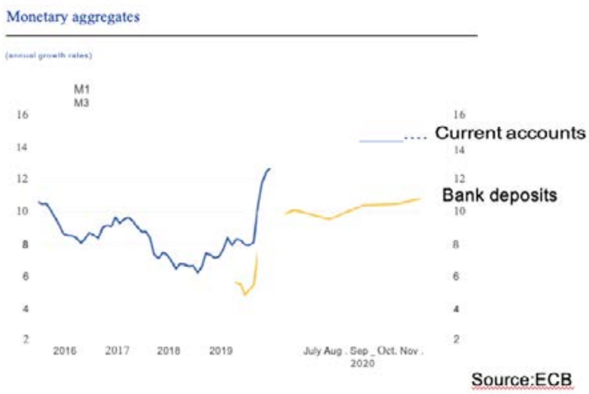
UK Money Supply Gowing 3x Normal Rate
Heavy lifting continues to be by the B of E
Commercial Banks cautious due to perceived risk



The US Money Supply Annual Rate Of Growth



Euroland Money Supply



Leaving the EU has increased the UK cost base. The £7Bn of customs' compliance costs will be passed on to consumers, and the Rules of Origin will result in unexpected tariffs on a range of products, both imported and exported.

The massive increase in the money supply will work its way through the economy as soon as restrictions are lifted. The housing market is already reflecting excess money supply with UK average house prices rising 7.3% last December.

Over this next year, the CPI index will not truly reflect reality. One of the main reasons is that leisure spending, which enjoys a 20% weighting in the index, is much reduced. The weightings are changed annually with a year's lag. Thus, my forecast of 4% will be proved wrong by the official data, but correct for the individual consumer. The official data will not reflect reality until 2023.

A HISTORY LESSON

There is commentary in the media that the post vaccination world will experience an effect similar to the 'Roaring Twenties' - 1920-29.

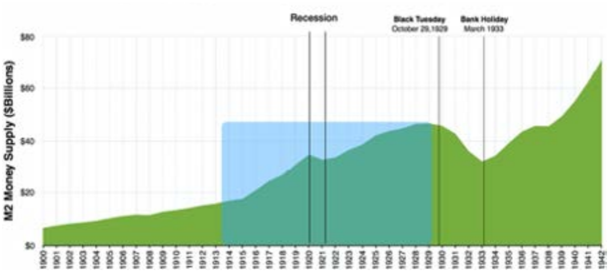
It is insightful to review the drivers and outcomes of that period; there are some significant similarities.

WW1 ended in 1918 after 4 years of conflict. The USA was both financier and food and materials' supplier to the Allies. The US Military was not active until 1917.

In 1916, Britain obtained 2/3 of its grain, 90% of its oil, 50% of its shell casings and a third of its engines from the USA. It paid for these in dollars, obtained by selling Gilts, denominated in dollars, to Americans! It cost $600Bn in today's money. The US economy flourished, supplying Europe (think China today!). Historians suggest that that was when the USA became the pre-eminent global economy, replacing the UK, which had been in relative decline since 1870.

The Federal Reserve was established in 1913. It came into existence to create stability for the US banking system which had experienced frequent meltdowns. The 1907 crash was the final straw, after which began the long process of establishing the Federal system of oversight and support. At this time, the World operated the Gold Standard. This required central banks to limit their creation of money to the value of gold they held in their vaults. Exchange rates were also fixed, and international debt settled with gold transfers. The gold standard was fixed at $20.67 per oz, and the exchange rate was £1 = $4.80.

Money Supply During The Great Depression Era



Almost all commodity trading accounts were settled in London. Just before the outbreak of WW1, US cotton traders rushed to settle their London accounts. The trading value of Sterling rose from $4.80 to $6.75 and there was a substantial outflow of gold from the USA to London. The recently established Federal Reserve immediately suspended the gold standard. This allowed US money supply to expand above gold holdings which remained. This was the first time QE had been used. It ensured the money supply grew to finance the expansion.

As soon as war broke out, the USA, which was neutral, saw the opportunity to supply resources to Britain and France. The UK was able to borrow freely given that Sterling was the equivalent of gold, and the bank of England had lots of gold! The UK national debt increased from £650m in 1914 to £7.4 Bn in 1919. Much of this was financed by the US. George Osborne paid off the last of this debt in 2014!

WW1 therefore allowed the USA to move to No.1 economy and creditor nation, unseating the UK. Meanwhile, the US money supply was growing at 7% from 1914 and many US business prospered. Federal Income tax was introduced in 1913.

However, by 1918, inflation was 18% and Spanish flu killed 600,000 Americans - and 500 million elsewhere. The switch from a war to a consumer production system was also only just beginning. A year later, the Fed doubled interest rates from 2% to 4% resulting in an 18-month recession, after which the increases were quickly reversed.

By 1922, everything came together. Mass production of consumer goods - particularly cars, electrification, highway construction, mass communication (radio and telephone), the expansion of consumer financing. Car manufacturers perfected assembly-line production and began to turn out cars at prices that would "put the middle classes on wheels". Public investment in a Federal highway system helped to expand the market even further. Other manufacturers adapted assembly-line techniques to produce affordable home appliances and consumer electronics: ovens, refrigerators, washing machines, phonographs, radios, telephones. And investment in utilities infrastructure: the electrical power grid, phone lines, water and sewer systems, helped to bring these products into more homes.

The key which unlocked the boom and helped to bring all these industrial and technological marvels within the reach of so many consumers was the expanded use of instalment credit, AKA debt. The big breakthrough came in 1919 when General Motors Acceptance Corporation (GMAC) became the first to make financing available to middle-income car buyers. Instead of having to come up with the entire purchase price, prospective car buyers needed only a down payment and enough income to cover the monthly payments over the life of the loan. Before long, manufacturers of other big-ticket items began to adopt the same practice. And if consumers were hesitant to go into debt, the flood of advertisements in mass media outlets — newspapers, magazines, and radio — helped them overcome their inhibitions.

After the ravages and widespread deaths of WW1 and Spanish 'flu, many people concluded that as life could be cut short, it was best to enjoy it while you could. The Roaring Twenties had arrived, fuelled by abundant credit i.e. new money.

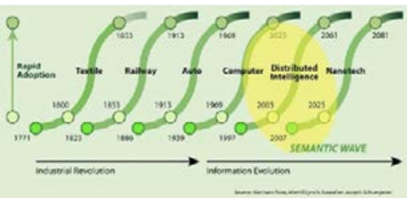
In 1920, President Hoover introduced prohibition aimed at reducing crime and corruption, solving social problems, reducing the tax burden created by prisons and poorhouses, and improving health and hygiene. It made the sale and manufacture of alcohol illegal. The result was a massive increase in both the illegal production and consumption of alcohol. The Kennedy family were leading players. Speakeasys appeared everywhere, with jazz musicians, dancing, and lot of fun. The act wasn't repealed until 1933! And, of course, it did not deliver. If people want to socialise with music and alcohol they will, regardless of legislation. Or rules.

The lessons from history are simple.
People will always want to meet face to face, drink and dance, even if it's illegal. Significant money growth always creates conditions for an economic boom, particularly when new technologies are available.

Towards the end of a boom, people always over-leverage and it always brings a day of reckoning (for example, the great crashes of 1929 and 2008). The next day of reckoning could be 2029.

Innovation is a big driver of growth. Look at the chart below. The application of nanotechnology is at the same stage of development as the auto industry and its supply chain was in 1913. Nanotechnology is behind the development of solar panels, modern pharma, fuel efficiency, coatings, food packaging, lightweight aircraft, lighter and higher capacity batteries.

The Innovation Curve



Eventually, microchips the size of a grain of rice will be able to be inserted into our hand. This could be our key to everything – identity for credit transactions, vaccination history, medical records, a key to open all electronic devices (no need for passwords, thank goodness!). All of us will need to be chipped if we want to travel, or access state benefits. The electronic identity card could enable a post Brexit UK to control its borders. The days of the plastic card which can be lost, forgotten or stolen would be a distant memory.

The business opportunities for this are massive. And as the adoption rate takes off, so will the real income per person. The much more efficient and effective new will drive out the old.

The UK's Roaring Twenties enjoyed only a short life. The expansion was brought to a shuddering halt by Winston Churchill's decision in 1925 to re-join the Gold Standard at the 1914 level. He had been Chancellor for less than a year and admitted he had no interest in finance or business. He was desperate to make his mark with the Conservative Party and was a deliberately, attention-seeking Chancellor. (sounds familiar?), He wanted his first budget to make a great splash, which it did, and much of the focus was on the return to Gold. Reluctant convert although he had been, Churchill was responsible and, if it be so judged, deserves much of the blame. It made almost all UK exports significantly overpriced. Wages were 68% higher in 1924 than in 1914. The General Strike in 1926 was caused by the miners who were told their wages would be cut by 13% and they would have to work an extra hour each shift. The strike was widely condemned by the British Gazette, a paper edited by Winston Churchill!

In the interests of balance, the Labour Party also supported the return to the Gold Standard. A young Treasury economist, John Maynard Keynes, fought hard against the decision. Britain then suffered seven years of misery due to a significantly overvalued currency, until Keynes won the argument, and the UK left the Gold Standard in 1931.

THE MARCH BUDGET

The overriding objective will be to do nothing which will moderate the coming boom. The Government needs to show the electorate that the decision to leave the EU has produced a UK growth rate superior to the EU.

My instinct is the big announcement will be the dropping of inflation targeting as the basis for setting interest rates. Instead, there will be a target for nominal GDP growth. I guess it will be set at 5-6%. This will allow for an inflation rate of up to 4%, without the requirement to raise interest rates.

Sunak may extend the stamp duty holiday until the Autumn budget.

He may also float the idea of a wealth tax to replace stamp duty (except for overseas purchasers) and council tax. Or just add it to the tax list as a one-off Covid tax. The wealth tax might be 1% of the market value of any property above the value of £300- 500k. It might be tapered above 1 million. I do not think such a tax will be implemented this year. But it could raise £60Bn and would be impossible to evade.

The Chancellor will argue that Covid has cost the NHS a fortune and that it is only fair that tax is raised to pay for it. He will not hit Income Tax, but will raise Corporation Tax to 25%, which is the average level for OECD countries. As the tax is paid in arrears, a booming economy will create the profit to be taxed.

He will reaffirm the commitment to spend £100Bn each year on infrastructure and borrow to fund it.

There will be a 2% tax on all online sales but no change in VAT.

He will talk about the need to get the National Debt down, but do nothing about it this year!

He is likely to move away from inflation targeting to setting a target for Nominal GDP. Probably at 5%. This will allow the B of E much more leeway on when - and by how much - to raise interest rates.

SCHOOL REPORT

Normally, you would get the report on how my forecasts and guesses have turned out, but as school has been shut for half the year, all I have is the Headmaster's note.

Martin-Fagg says he has been diligently working at home. However, there are rumours that he has been seen tearing around the Chiltern Hills on his EMTB. We will produce a report when we have more evidence that he has been working, rather than mountain biking.

BREXIT

I continue to be amazed by the lack of understanding as to what Brexit actually means.

To summarise,
There is a 1200 page legal agreement which unwinds 40 years of legal agreements with members of the EU. This has not yet been signed off by the EU Parliament.

The key is we have left the single market, but there is a free trade agreement on goods. This agreement means no tariffs or quotas. The single market, which was our idea, was designed to minimise the cost of trading across borders. The intention was to boost exports from SMEs who find paperwork and officialdom an expensive chore. It took years to bed in, but now works well for members of the EU.

The UK is now an external country – a 3rd country - and can no longer benefit from the single market (unless an SME sets up an EU subsidiary). The cost of trading with the EU has risen and will remain. There are £7Bn of new costs for health checks, customs declarations and so on. Our haulage industry has lost cabotage rights which has raised the cost of exporting. For many smaller companies, exporting to the EU will result in reduced margins and many are likely to give up. And minor niggles like green cards and dog passports are now required.

The free trade deal is tariff and quota free, unless a committee decides that either party is competing unfairly in which case tariffs can be introduced.

There is no free trade deal for services. There is the requirement for UK financial services regulation to be assessed as equivalent to ensure access to EU markets. This can be withdrawn at 30 days' notice. Currently only a small number of service activities are deemed equivalent. But naturally there are teams on both sides working on a way forward. It is likely the UK will go it alone and take the consequences.

The rules of origin are complicated and currently some businesses are discovering that a tariff is payable if they import from China, add value and then export to the EU.

There will be years' of work to make sure the whole divorce is being honoured as agreed. For the EU, until four years' ago, all their work was with third countries who wanted to join; we are the only leaver. So Brexit has required significant changes in their mindset which as we know has caused a lot of misunderstanding.

It is clear Boris and the ERG wanted what they call sovereignty. And they assume the voters wanted the same. I expect that the economic cost will significantly outweigh the benefits in the next few years, until we adapt. But at least no British Government can any longer blame the EU for bad policy, incompetently delivered. However, economic performance always depends on individual businesses and I have every belief that the majority will adapt and flourish.

The Government has promised much more support to the private sector for innovation. The success with vaccines is an excellent start, and there is more technology support in the pipeline.

This is a wake-up call for the Brussels bureaucracy. The British are not alone in disliking the overreach into members states' way of life. The recent debacle with the vaccine and the clear over-reach of Brussels should drive significant changes in Brussels over the next few years, and it's likely that in seven years' time, the EU will be operating in way which we could find attractive!

The single market and free movement of goods, capital and people is a brilliant model. But the Euro, and the idea behind it, which is a truly federal Europe, does not sit comfortably with most member states. The EU is good at running a trading bloc but that's where it ends, as the vaccine debacle clearly illustrates.

The economics of trade are best expressed by this chart. Essentially, as geographic distance doubles, physical trade halves except for finance and technology.

Geography Matters For Trade Volumes As Much As In Services And Goods

UK's Top Trade Partners (2017-19)

UK business is resilient and creative, and many SMEs see the EU as only one of many markets they already supply and will just add the new requirements to an already long list.

The freight forwarders will quickly get up to speed as all the new requirements are built into their software. It will of course increase costs.

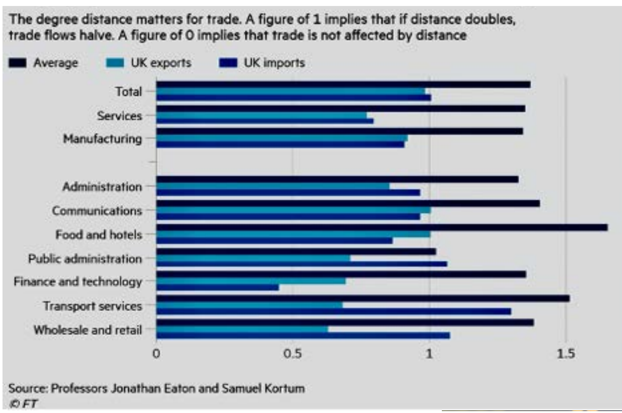
London, as a financial powerhouse, will continue to adapt. Its creativity and the clusters of legal, IT, PR, and digital marketing companies which support it will ensure success. But there will be winners and losers. Particularly if the EU is harsh in applying the equivalence requirement.

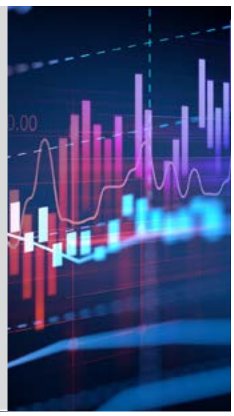
Last year the UK surged ahead in digital fintech attracting 432 projects (36% increase), representing a 30% share of all European FDI projects, more than France and Germany combined.

Covid plus Brexit, plus modern monetary theory in action means the UK and the world are entering a period of rapid change, financed by plentiful, cheap money.

It may be counterintuitive, but now is probably a very good time to start or expand a business. Covid has broken some of the traditions such as 'Everyone being in the office, or 'Online is only for big retail', or 'Home working has too many distractions'. So, for the truly innovative, possibilities abound.

There is also now clear evidence that cutting taxes for the already rich does not result in significant trickle down to the poor, because inequality in rich countries is primarily wealth, not income based.





Finally, I came across this. It is a simplification but gives food for thought. Note that Generation Z are now the largest proportion of the population. It may be because I am a baby-boomer, but I do not see much evidence that Government understands this cohort, who will employ new methods (and maybe social media) to demand changes which the boomers will not understand, and will probably resist.

I notice that Indonesia is vaccinating youngsters before the oldies. There is some merit in this approach. Discuss.

EXCHANGE RATES

There are minimal differences in major economies' interest and inflation rates. The big differences are in money supply growth. The USA and Canada lead the pack with 25% growth in money supply; then we have the EU and the UK at 14%. This will cause the dollar to weaken, and Sterling and the Euro to strengthen against the dollar. So £-$1.38.

Generation	Silent	Baby Boomers	Gen X	Millennials	Gen Z
Years born	1928-1945	1946-1964	1965-1980	1981-1995	1995-2010
% of population	3%	11%	19%	22%	32%
Life defining events	- WWI and WWII - Great depression	- Cold war - Moon Landing - Transistor invented	- End of cold war - Live Aid - Computer	- 9/11 - GFC - Social media	- COVID-19 - MeToo/LGBT/BLM - Carbon free energy
Key technology	Car	TV	PC	Smart phone	AR/VR
Hobby	Reading	Watching TV	Surfing the net	Music streaming	Gaming/ Video streaming
Clothing	Anything comfy	Chinos (they were cool once)	Jeans	Athleisure	Recycled apparel
Greatest fear	2020	Being blamed - they had it all	Lost generation	- Student debt - Environment	- Low batteries - Environment
Iconic figure	Churchill	Margaret Thatcher	Bill Gates	Mark Zuckerberg	Greta Thunberg
Travel type	Jaguar	4x4	Prius	Mum's Prius	Why drive/fly?
Key life question	How did it all go so very wrong?	Will I be able to afford to retire?	What's the point?	What's a career?	What's a landline?
Social network	The Rotary Club	Pub	Facebook	Instagram	Youtube/TikTok

Sterling is likely to sit around 1.12-15 Euro, as is still early days on how the UK will perform as a Third country.

Finally, The UK Housing Market

It has been running hot since last May. Normal transaction volumes are 100,000 per month; we have seen steady increases over the past 7 months. December 2020 is estimated at 129,000. Most observers think the stamp duty holiday is the main driver of demand. I think it is certainly a positive influence, but I would cite very low interest rates, massive money supply growth, forced savings of £100Bn, the need for space, the opinion that property is a great inflation hedge, and freedom from Capital Gains Tax as other drivers.

So far this year demand has softened. I believe this is primarily due to potential sellers not wanting hordes of strangers visiting their houses. I expect supply and demand to recover after the end of March. The first quarter dip will bring the average annual transactions back to the 100,000 level. And I still think average prices will be up 7% this year - that is unless the Chancellor announces a property tax next month with a low threshold.

CONCLUSION

The lockdowns reduce output and expenditure, but not incomes, to the same extent. For example, in 2020, UK real GDP fell 10% but household real incomes increased. The consequence is significant pent-up demand. This will surge when freedom is restored, hopefully in Q2. If there are no further lockdowns, this will cause inflationary growth. This will not result in higher interest rates unless and until wages take off.

There will be severe shortages of the right types of employees so now is the time to improve the performance of existing employees, using new technology.

Equity and house prices will continue to grow. Equities will outperform property over the next few years because company profits will rise, but the threat of property tax is real.

Are you ready for the coming boom!

STOP PRESS, FROM THE USA LATEST INFLATION DATA:

% Increase over last year...
Ethereum: +683%
Bitcoin: +363%
Lumber: +115%
Soybeans: +59%
Silver: +55%
Copper: +46%
Corn: +45%
Cotton: +30%
Coffee: +25%
S&P 500: +20%
Gold: +17%
Crude Oil: +16%
Wheat: +16%
US Home Prices: +10%

US Consumer Price Index : +1.4%

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Roger is a graduate of the University of Leicester. He has worked in the New Zealand Treasury, at the Bank of England and, for many years, was Client Director at Henley Management College where he worked with a wide range of businesses. He is a behavioural economist who believes that economic forecasting is an art, not a science and that it is crucial to estimate the nature, size and impact of 'animal spirits' when looking forwards. He believes that Government cannot control the economy; it can only influence the behaviour of economic agents. He was one of the few who forecast the depth of the recent recession based on his anticipation of the behaviour of the banking system. He thinks it is better to be broadly right than precisely wrong when forecasting the future!