ECONOMIC UPDATE MAY 2021

Over this past year, like most other professional people, I have been zooming, emailing and telephoning. And I have come to realise that if communication is not face to face, the content has to be kept simple, clear and without caveats.

This update will be just that, with apologies to those who like to delve into the more arcane and complicated area of how the economy works and Government's attempts to improve life for its population.

THE DEVELOPMENT OF ECONOMIC THINKING

Economics is the study of how humans earn a living by interacting with each other and the natural environment.

They do this by doing something that others will willingly pay for.

The first popular economist was Adam Smith a Scot who went to Glasgow Uni. aged 14. In 1740, Glasgow was the epicentre of moral philosophical thinking. Smith then went to Balliol College, Oxford which, after Glasgow, was a desert of intellectual thinking. He returned to Glasgow after six years to join the University.

Among his wide circle of acquaintances were not only members of the aristocracy, many connected with the government, but also a range of intellectual and scientific figures that included Joseph Black, a pioneer in the field of chemistry; James Watt, later of steam-engine fame; Robert Foulis, a distinguished printer and publisher and subsequent founder of the first British Academy of Design; and, not least, the philosopher David Hume, a lifelong friend whom Smith had met in Edinburgh.

During these years, Smith was also introduced into the company of the great merchants who were carrying on the colonial trade that had opened to Scotland following its union with England in 1707. One of them, Andrew Cochrane, had been a provost of Glasgow and had founded the famous Political Economy Club. From Cochrane and his fellow merchants Smith undoubtedly acquired the detailed understanding of trade and business that was to give such a sense of the real world to *The Wealth of Nations.*

The Wealth of Nations was a description of business life as observed by Smith. There is a section where Smith describes a pin factory to illustrate the productivity gains from the division of labour. He made this up to illustrate the process, but many erroneously believe it was an actual business!

Apart from the pin factory example, the book was descriptive and not theoretical.

For the next 100 years, Political Economy continued to be expressive of life as the Industrial Revolution gathered momentum.

By 1880, the physical sciences were making significant advances and late-Victorian Britain believed science could solve all man's problems. The Royal Society was the centre of advanced thinking.

Classical economics reached its zenith in 1880 with classical economists reorienting economics away from an analysis of the King's personal concerns to broader national interests. Adam Smith identified the wealth of a nation with the yearly national income, instead of the King's treasury. Smith saw this income as produced by labour, land, and capital. With property rights to land and capital held by individuals, the national income is divided between labourers, landlords, and capitalists in the form of wages, rent, and interest or profits. In his vision, productive labour was the true source of income, while capital was the main organising force, boosting labour's productivity and inducing growth.

In 1880, Neo-classical economics began to be developed. It was an attempt to make economics a science. It introduced the concept of supply and demand as an approach to price determination. It assumed rational behaviour by all individuals who, as consumers, would always seek to maximise utility and by owners of a business or land who would always seek to maximise their profits.

The supply and demand approach allowed algebraic formulae to be applied and to calculate optimal outcomes. The key to this approach is the belief that maximizing, rational, people would constantly adapt to price changes. And crucially, that the economy is self-regulating with only a limited role for Government.

If resources were not fully employed, then prices would fall until they were.

The so-called laws of supply and demand would ensure any economy would reach full employment equilibrium.

In the period 1920-30, Neo-classical thinking resulted in the General Strike of 1926 and the Great Depression of 1929-33.

John Maynard Keynes was the first behavioural economist. He pointed out the limitations of neo-classical thinking which was that rational behaviour and the laws of supply and demand would ensure the economy as a whole would operate like a single market. There would always be full employment providing wages were allowed to fall.

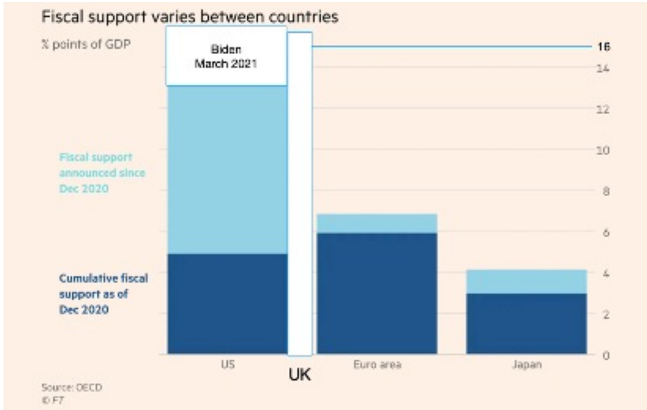
He showed that when business loses confidence for whatever reason, output falls and unemployment rises, regardless of wage levels, and the whole system enters a downward spiral, deepening because those with sufficient income would save out of fear. He was clear that it is the role of Government to step in to prevent this.

That is where we are today. Most major economies are currently operating Keynesian policies.

The economically illiterate call it socialism. Keynes did not advocate Government continuously increasing its share of GDP. He was clear that, when the private sector had gained sufficient confidence to invest and spend, Government should reduce its role and stimulus.

I keep reading that Biden is a Marxist. Marx pointed out that, over time, the returns to capital grow faster than the returns to labour. Piketty, a French economist, has shown this is an undeniable fact and that, if economies are to expand and prosper, using the tax system to redistribute some of the wealth to those who actually created it is a good idea. If the wealth is unearned – e,g. when a piece of agricultural land is allowed to be used for housing and its value is quadrupled - then a significant capital gains tax makes sense and is certainly not unfair.

How much support are Governments giving to their respective economies and what out-comes should we expect?



The two countries which stand out are the USA and the UK. Both will be borrowing and spending 17% of GDP this year.

This is new money created out of thin air by their respective central banks. It is not money from taxpayers or borrowed from savers. Which is why long run interest rates in the UK and the USA are 1.6% despite massive Government borrowing. Both economies will experience a surge in growth in the second half of this year, tax receipts will rise significantly, and the central bank 'tap' will probably be turned down or off. Job done.

If long run interest rates rise significantly because of inflationary expectations, I would expect the money tap to be turned up again to keep rates low. So do not expect any significant rise in rates for at least 18 months. The inflation rate will increase to 4% over the next 18 months. But interest rates will be lower.

It is worth pointing out there are two rates of interest. The current 0.1% (bank rate) is the rate of interest the central bank pays to commercial banks on the deposits they are required to keep at the central bank. It's an operating cost for a bank and it will mark up its price for short term lending based on it. It's called the short run rate, the Minimum Lending Rate, the policy rate. It is decided upon every month by a committee at the central bank. Central banks have an inflation target set by their respective Governments. They move the policy rate to deliver the target.

The other rate is the long run rate. This is the yield on 10 year Government bonds. This rate is determined by the supply and demand for bonds on a daily basis. As the price of bonds in the market rise, the rate falls. It's arithmetic. The rate is currently 1.63%.

The bonds are the national debt. The cost of financing goes up if bond prices fall. And vice versa. All new bonds are auctioned monthly by a branch of the Treasury. The bidders are banks, insurance companies and pension funds. All three need to hold at least a third of their assets in these bonds. This is because the bonds can always be sold to the central bank for cash if required.

Central banks are not normally involved in the auction. However, when the economy is stressed (usually because banks are stressed), the central bank takes part in the auction. It's called quantitative easing. The central bank creates digital money and pays the highest price at the auction, thus keeping long-run interest rates low. Currently 1.63%. But it changes every day if you are about to check it on line!

The mortgage rate is linked to the long rate. An 80%, two-year, fixed rate mortgage is currently 3.5%, plus charges. So the margin for a lender is between 2% and 3%.

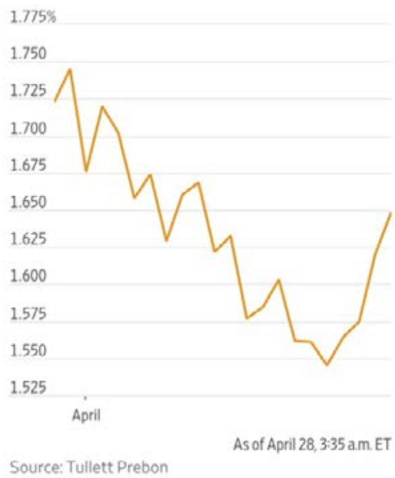
SO, IN SUMMARY:

> The current 0.1% rate is reviewed each month. It is not determined by supply and demand but by the outlook for inflation and the opinion of eight wise members of the MPC.

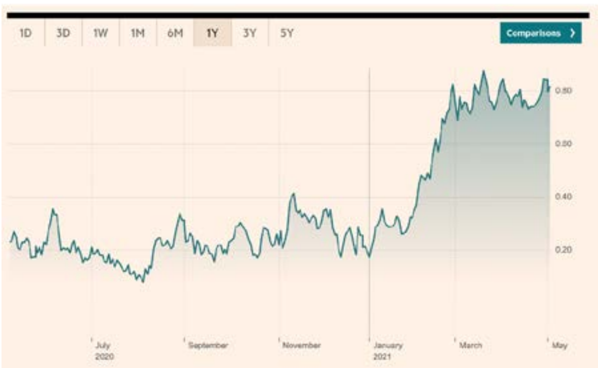
> The long rate, currently 0.8%, is determined by supply and demand. When there is QE, the central bank is the dominant player. So it is fair to say the long rate is currently determined by the central bank as well.

> Over the next year, if inflationary expectations of the market increase and the central bank gives no further assistance, the long rate will rise. If the view of the monetary policy committee is that inflation is unlikely, the policy rate will not rise.

Yield on 10 year US. Treasury Note



I expect this will happen over the next 12 months - Policy rate 0.1%; long rate 1.5%. The chart shows the daily change in the US long run rate.



Yield on 10 year U.K. gilt

The EU stimulus is much smaller, and it's recovery will thus be weaker. China is back to normal currently growing at 6%

Government financing of employee wages and business costs has been very successful and productive capacity has been largely maintained, other than for non-online retail and hospitality. Every pub but one within six miles of my house is posting staff-wanted signs. And on the first day pubs could sell beer, 6 million pints were sold in their gardens.

A year ago, 9 million were furloughed; now it's circa 3.5 million, and unemployment has fallen to 5%. Assuming no further lockdowns, in six months' time, the constraint on growth will be labour supply.

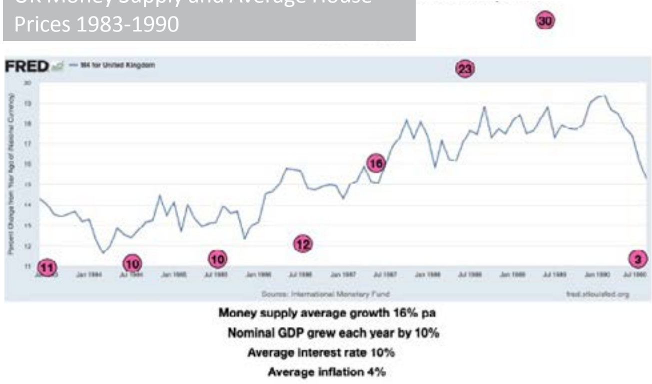
There is very little accommodation now available in UK holiday areas, and prices are rising.

There is £180Bn in household accounts ready to be spent - nearly an entire month's GDP.

The way I see it, businesses should expect to sell 13 months of output in 12 months. This will stretch existing capacity, but as an encouragement to expand, remember the 130% capital investment allowance. Again, available equipment and labour will be the constraint on expansion.

The danger now for the USA and the UK is excess demand leading to much higher-than-expected inflation. But as I have said, this will take 18 months to emerge.

UK Money Supply and Average House Prices 1983-1990



In the go go Thatcher years, the economy managed 4% real growth for four years - 70% more than trend - but as some of you will remember, it ended in inflationary tears in 1989, and Barclays and NatWest were nearly insolvent. The 4% growth rate was made possible because of very large increases in the money supply and a large pool of labour (over 3 million unemployed).

Money supply growth averaged 16% pa. Growth hit capacity constraint by 1988 and, a year later, inflation was 9%.

The stand out feature was the massive increase in house prices. Look at the chart. Those who were on the property ladder in the early eighties enjoyed significant increases in wealth. Which of course made Mrs.T a popular PM.

UK Money Supply and Average House Prices 1990-2000

It's laughable to say Mrs T and her Government controlled the money supply. Just look at the chart. At no point was annual growth less than 12% and it was all was created by commercial banks. Also, the average growth in GDP at 2.6% was no better than the previous decade or the following decade. However, those who were on the housing ladder doubled their wealth. Hence the fond memories.

The crash came in 1990. The trigger was the Berlin Wall coming down in late 1989. The UK joined the ERM in 1990 because the PM was told it would significantly reduce inflation. What she wasn't told is that the ERM was dominated by the D mark, the value of which soared as Germany increased interest rates and we had to follow suit. German rates soared because the East Germans were allowed to switch their currency into D marks at one for one. And suddenly, were able to afford all the products produced by a capitalist system. Two-year-old BMWs were changing hands at more than the list price of a new ones!

Barclays and NatWest called in many overdrafts and lots of smaller businesses failed.

Why am I telling you all this?

History does repeat itself, not in exactly the same way, but none the less with strong similarities.

In a previous update I described the roaring twenties which ended in the big crash of 1929.

The property boom years of the eighties ended in the big crash of 1990-92.

The period 1992-2002 was the most stable, before excess money began to flood through the pipe after a relaxation of banking regulations. NB - UK banks are currently asking for a relaxation of the controls introduced after the 2008 crash.

It is not unreasonable to suggest we will enjoy five really good years before another crash around 2028.There will be plenty of warning signals two years before it happens.

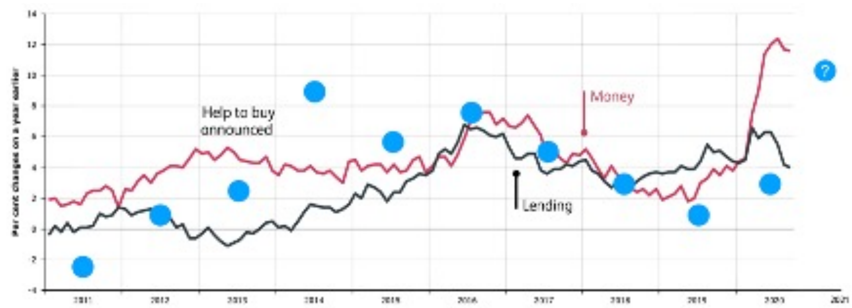
As Keynes said, in the long run we are all dead so best not to dwell on it now!

The current position

I hope I have convinced you that we are in for a significant boom. And I am sure many of you are prepared.

The IMF announced two weeks ago that they estimate there is now $6.0 trillion of global saving waiting to be spent. This is nearly twice the size of the UK economy.

Money supply growth indicates circa 7-10% increase in average selling proces in 2021



Bank of England Land Registry

The money supply is growing at 12%. BUT it's not due to commercial bank lending which is growing at a stable rate of 4%. The difference is the Bank of England creating new money to finance covid support and infrastructure spending. The covid support is going straight into household and business bank accounts. And when it flows out, it will stimulate more commercial bank lending, particularly for house purchases.

Unlike the eighties we do not have a large labour pool to draw on. The good news is labour substitution will gather pace with software and automation. So as white-collar workers are displaced by software in business A, they will quickly obtain work in business B.

Of course, the Government could slow the whole system down by significantly raising taxes, particularly on wealth. But they won't; not yet anyway!

I have illustrated my thoughts with reference to the UK. But the USA will exhibit the same pattern, but bigger and better (because they have much more land and, thanks to immigration, lots of young people to do the new work as it arrives.)

We wait to see how effective the vaccines are. It's encouraging that the return of school children has not produced a surge in infections.

It is likely that Covid will be a regular feature of modern life so like the flu, we will learn to adapt to it and live our lives.

They are now expecting World trade to grow at twice the normal rate of 4%. Yes, there are risks such as the second waves in India and Brazil but if the USA, Europe and China avoid further lockdowns then the second half of this year will show all the signs of a boom.

WHAT DOES ALL THIS MEAN IF YOU ARE RUNNING A BUSINESS?

1. People, people, people. Pay well; treat well; give ample support for training.
2. Automate back-office functions where possible.
3. Be prepared for suitors who want to buy your business or merge it with theirs - 80% of mergers and acquisitions fail to deliver the expected returns - or come to you with lists of businesses they think you should buy with their financing.
4. Do not take on too much long-term debt, unless you can fix at a rate below 5% and you are convinced the return will be 10% plus.
5. Remember, as a general rule, rapid growth and expansion in the number of direct employees usually takes the fun out of things. So, if you are intending to go big, make sure you are mentally prepared to change your way of working from being a member of the orchestra to that of the conductor.

6 Basically, ignore most of the media, particularly when the economic journalists are youngsters.

7 Get and stay physically fit - reduces risk of being really ill with Covid.

And above all be wary of economists who think they know how things might turn out!

So having said that, here are my forecasts to the end of the year.

No doubt the scribblers will hail a massive recovery in retail for April this year compared to lockdown April last year. This will be misleading.

- By the end of this year average UK house price will up up 10% (London 3%- North West 12%)
- CPI inflation 3 - 4%
- Materials shortages throughout the year as Covid significantly reduces shipping capacity.
- Wage growth will be 4-5%
- Labour shortages in all sectors
- Long run interest rate 1.5%; policy rate 0.25%
- UK share prices on average up 6%
- Exchange rate $1.42; Euro 1.20
- Hospitality will boom
- The High Street will recover, but only for distinctive and compelling stores.
- The EU will continue to suffer from the ineptness of Brussels on vaccines and covid support.

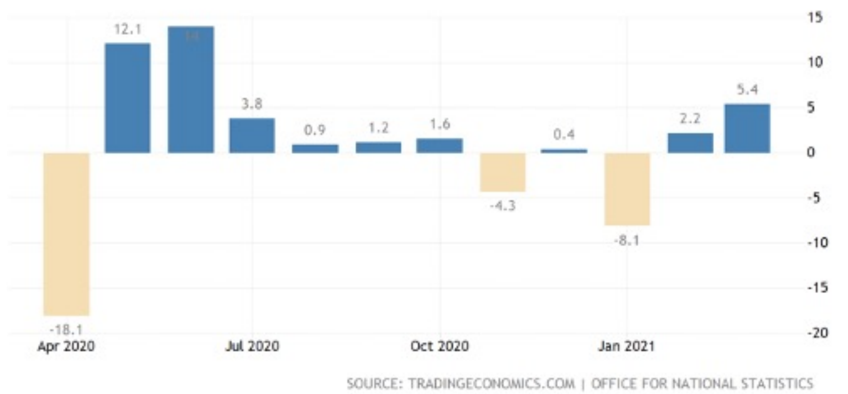
Some of us expected Brexit to expose the nature of the Commission, and it has. The ramifications for the EU and the UK are only just beginning. The Withdrawal Agreement has been ratified by the EU Parliament but there is growing unease about the way the EU is behaving. We should expect continuous wrangling over the rules and their interpretation by both sides.

It will continue to be difficult for SMEs who have only ever known a frictionless market in the EU and now face considerable paperwork, slower delivery times, and hauliers unwilling to take small loads. Through time, things will bed down, but it will take a number of years.

Finally data this year will be misleading. Retail sales data typically reports a month compared to the same month a year earlier. But if last year it was a lockdown month, it makes no sense to compare it with a no-lockdown month this year. So it's best to look at month-on-month until the extreme data points are taken out by passing time.

On this page you'll see the difference between mom and yoy data and what it tells us.

UK Retail Sales % Change Month on Month



NB year on year comparisons not helpful if previous year was a lock down month

UK Retail Sales Year on Year

Finally, the last year has shown just how adaptable SME owners and their employees are. This bodes well for growth as they are 60% of the economy. Early indicators show productivity gains due to home working. This will become permanent with widespread hybrid working.

With so much money sloshing around, all sorts will be contacting owners suggesting mergers and takeovers. And the pluses will be listed as market share, growth, economies of scale, greater pricing power, fatter margins, more status. What is never mentioned are the diseconomies of management, culture, and slowness to react to changing conditions. So, if you are tempted to get bigger in this way, make sure you fully understand these diseconomies. 80% of mergers and acquisitions destroy value.

Have a great Summer!

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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!