ECONOMIC UPDATE AUGUST 2021

This update will consider whether the current rise in inflation around the World is a short-term blip or the beginning of a new inflationary growth cycle.

THE BASICS

The wide variety of available inflationary measures each have something to offer analysts - and politicians!

The Retail Price Index (RPI) was first introduced after WW1. In 1992, Chancellor of the Exchequer Norman Lamont decided to remove mortgage interest payments from the index and rename it RPIX. Since 2017, the main index has been CPIH, which is basically RPI, plus owner-occupier housing costs. CPIH calculates the basic price increases on 700 different categories of goods and services from data supplied by 120,000 retail outlets.

It takes the geometric mean of prices. This means it calculates the central tendency or typical value of a set of numbers. This approach assumes that consumers will buy less of something if the price goes up and more if the price goes down. The practical consequence is that CPIH will always indicate a lower inflation rate than RPI, which is based on arithmetic means of individual numbers.

So what? Well, RPI and its methodology is considered to be unfit for purpose and is no longer used.

The index is weighted based on recent household expenditure patterns, the data from which comes from household expenditure surveys.

Housing costs are 30% of the index; next is recreation and culture at 13.6%; then transport at 12%. Food is a lowly 8%, below restaurants and hotels at 9.6%.

So simply put, rising energy prices push up the index more than rising food prices. An increase in the price of oil is more inflationary than an increase in the price of wheat.

The latest UK inflation rate is 2.1%, up from 1.6% in April, primarily due to rising transport costs.

The fact that May 2020 was a lockdown month is not relevant because the index is based to 2015.

The most recent data from the USA shows CPI 8% higher than a year earlier, which was not a lockdown month.

DEFINITIONS AND THOUGHTS

The best definition of inflation is 'too much money chasing too few goods, services and people'. Clearly lockdown reduces the supply of goods and some services. Assuming no further lockdowns, the supply of goods and services will increase. However, the growth in money supply in the USA and the UK suggests that, even with increased supply, average price levels will be higher for a year or so, and possibly longer.

Since Covid, the big price increases have been in equities and real estate. Central bankers tend to ignore rampant asset price inflation. For the politicians, it is popular. Middle class property owners like it, and the very rich love it as their equity wealth soars.

Export prices out of China are rising by 10%, the surge in transport prices will abate as containers become positioned in the right locations, and the crews of all the vessels are vaccinated.

The main drivers of a rising rate of inflation is wage growth above productivity growth, and money supply expanding above trend.

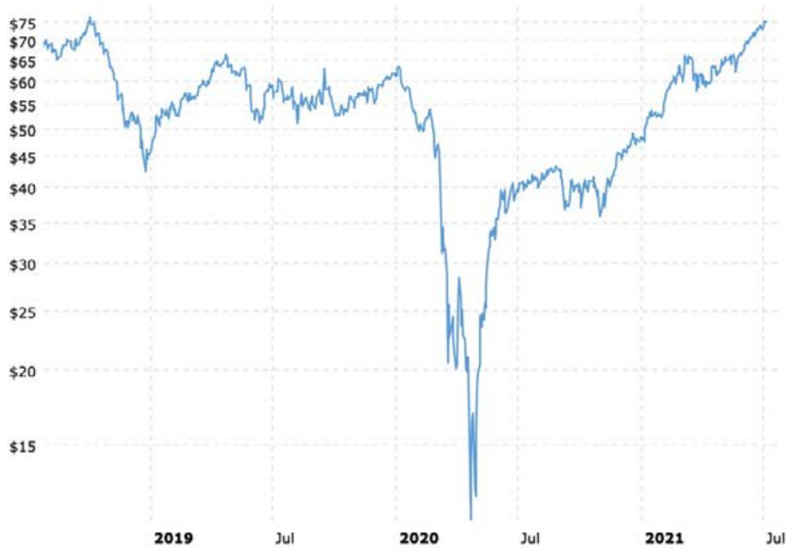
Wage growth above productivity growth is caused by tight labour markets, which in turn is due to full employment. Australia and NZ are suffering significant labour shortages due to the closing of their borders, the UK due to Brexit and the USA due to handouts dissuading some from work-ing.

If a business has the power to set prices, increasing wage costs will be fully passed on. So think top level lawyers, management consultants, IT specialists.

THE UK INFLATION RATE

CPIH Annual Rate 00: All Items 2015 = 100

The Price of Oil

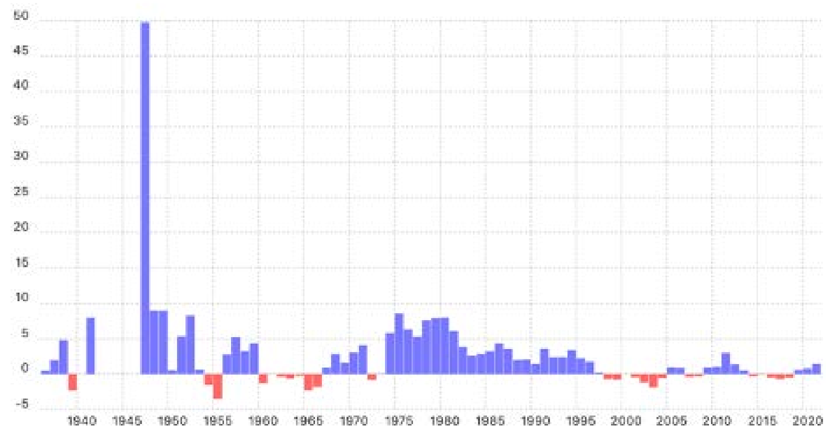


Oil prices have increased because of the failure of OPEC to agree increased production quotas in the face of rising global demand. The breakeven price for all oil producers is $93; the Saudis need $77 to meet their budget, Russia needs $72 and the UAE $65. So we should expect further increases, moderated by the US, who are not members of OPEC, increasing supply.

SO WHAT ARE THE PROSPECTS FOR PERMANENTLY HIGHER INFLATION?

If we look at rich countries where manufacturing accounts for less than 20% of GDP, what hap-pens to wage growth and productivity in the services sector is key. Globally, manufacturing is better at improving productivity than the service sector. Consequently, rising wages in manufac-turing does not result in a similar increase in prices. For example, labour cost as a proportion of output for a car manufacturer is around 12%; for a typical restaurant 30-40%; for the NHS 45%, and for a law firm 70%.

Price Inflation for New Cars since 1935 *(Consumer Price Index, US Bureau of Labor Statistics)*



Years with the largest changes in pricing: 1947 *(49.78%)*, 1948 *(8.97%)*, and 1949 *(8.95%)*.

For businesses without price-setting power, margins will remain depressed for a period, during which the firm looks to automate and outsource. Both will be aimed at increasing the productivity of a smaller labour force. A good example is Amazon. Four years ago, pickers processed 100 orders an hour. Extensive robotization has increased this to 300. Given the demographic profile of many wealthy countries, this is both essential and inevitable.

In reality, the key drivers of innovation and the resultant productivity gains are wage pressure from the market and the Government raising minimum wages.

The minimum wage in France has been higher than the UK's for many years. Their productivity per hour of work is consistently higher, mainly because they work fewer hours per year and most importantly, they employ fewer under-performers - which is why their unemployment rate is consistently higher.

The average Brit works 1674 hours, each year; in France 1482 and in Germany 1371. Total output in France and the UK is almost the same, but we spend longer to produce it!

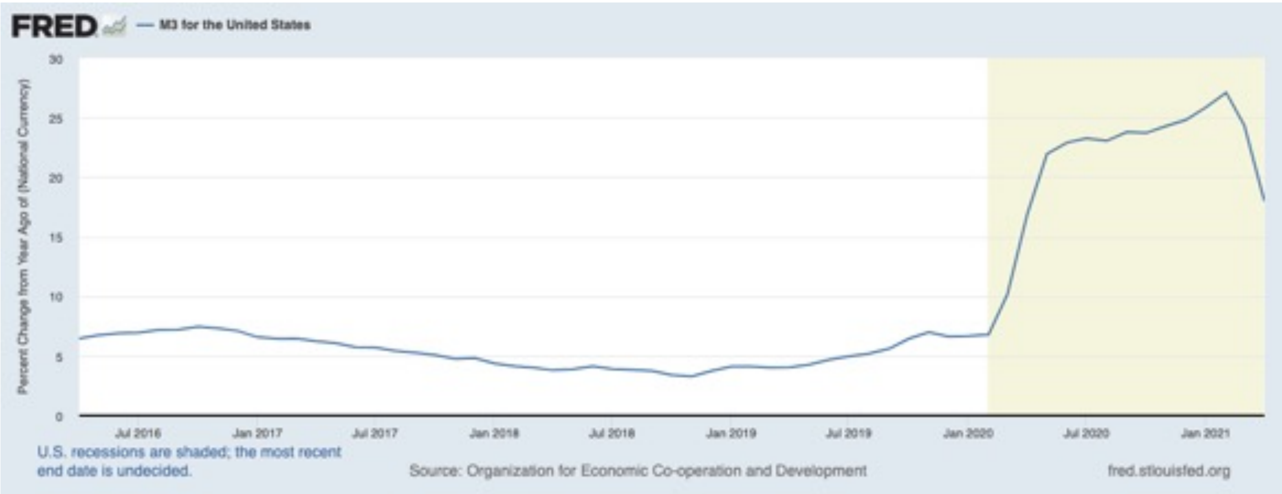
the Governor of the B of E. He said when the MPC raises bank rate to 1.5%, the bank will cease further QE. Then the yield on Gilts will begin to rise from the current 0.8%, with mortgage rates following. This is from the minutes of the May meeting:

In the central projections of the MPC's May Report, the economy experiences a temporary period of strong GDP growth and a temporary period of modestly above-target CPI inflation, after which growth and inflation fall back, with inflation around the target two and three years ahead.

Please note that the track record of the MPC in forecasting growth and inflation is not good. But they think that inflation will be above 2% for the next two to three years. The level is not specified.

If wage growth runs at 5-6% over the next 18 months, then expect MPC interest rates to rise towards 1.5%.

The Federal Reserve have said they will not raise rates until 2023 and continue to supply $125Bn a month of new money to their economy. But I would expect opinion to change in the Autumn.



THE MONEY SUPPLY

Over the past 16 months, money supply in major economies has expanded massively due to Covid-support financing from Central Banks. Lending by commercial banks is only slightly above normal. The new money is now in the accounts of households and businesses. Clearly this stimulus has propelled equity and real estate prices to record highs. From now, I expect much greater flows into hospitality and recreation and that the prices charged by both these sectors will increase. As these two sectors enjoy a much-needed boost, I expect retail sales to soften giving the supply chains time to catch up. But unusual weather patterns, repeated lockdowns, and erratic levels of demand will result in supply disruption for the next two years, and possibly longer.

The core issue however is that when money is spent, it continues to exist to be spent again. There is $20 trillion more money in circulation in the world than 17 months ago. That is the equivalent of the USA's GNP for a year.

The question is when will Central Banks turn off the money tap?

The only indicator we have for the UK is a recent comment by

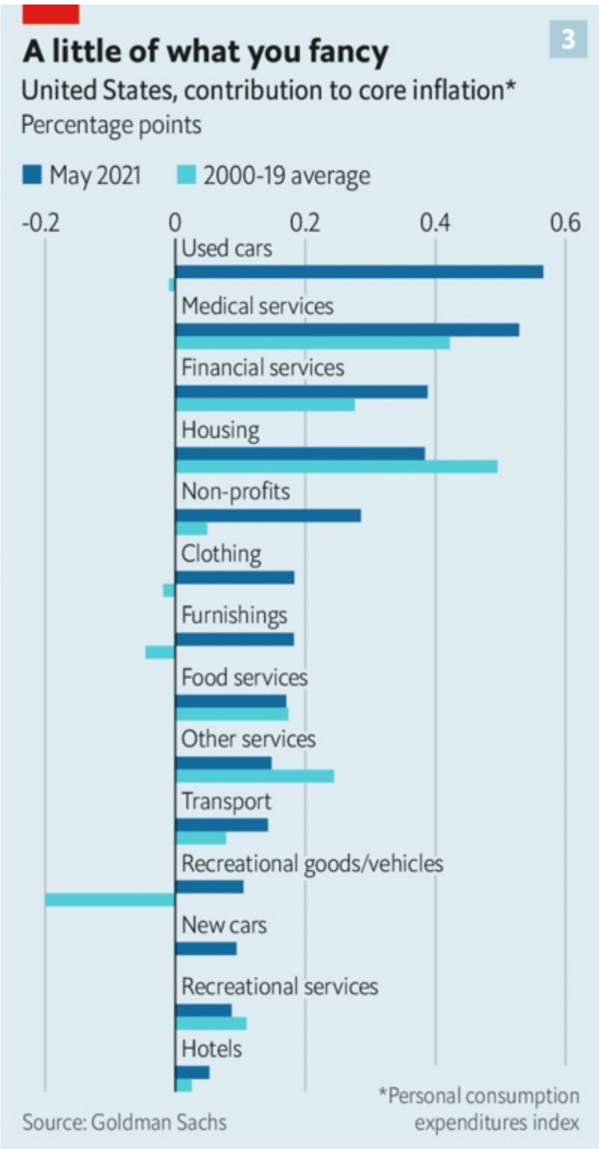
Their money supply is currently growing at 18% yoy. Inflation-free growth rate should be 6%.

As you can see from the chart below, used cars top the inflation list because new cars are in short supply due to lack of semiconductors. Medical services are next which is not surprising given Covid. Then Financial services, which is clearly driven by excess money; 'people have more money so let's take it off them!' Housing is seen as an investment so rising prices cause further price rises - the so called "bigger fool" hypothesis.

It is clear, given the size of the stimulus, the USA is overheating. Core inflation is rising at 8.3%.

Turning to Europe, the ECB have said they will continue QE until March next year. And have an-nounced that they will be not too concerned if inflation runs above their 2% target. This is a signif-icant shift in attitude, and follows on from the Federal Reserve approach which is to average infla-tion over a number years.

In essence, this means that the most influential central banks in the World are happy to see infla-tion above 2%, which in turn means any necessary increase in interest rates will be delayed.

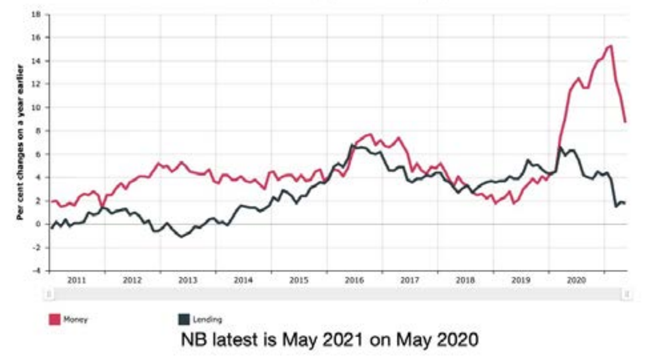


EU money supply is growing at 8.5%. Normal is 5%.

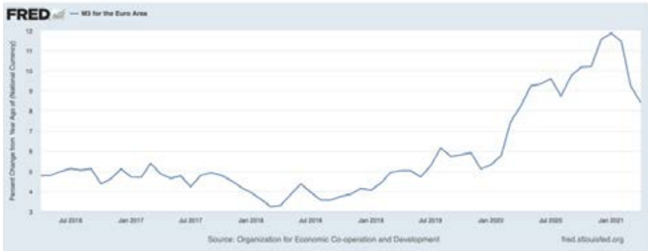
The ECB have also said they are going - at last – to include housing costs in their CPI index of inflation. This will certainly take the rate of inflation close to 3% given the 10% increase in German
house prices.

The Bank of England is currently sending mixed messages. The latest is that the current stimulus will be continued until the Monetary Policy Committee have raised base rate to 1.5%, at which point they may begin to reduce the stimulus.

UK Money Supply Growth yoy



Eurozone Money Supply



History to date indicates that central Banks are always behind the curve. They delay increases in rates and then when it's too late, they have to increase them by more to rein in our animal spirits.

In fairness to them, Covid is a new Black Swan event and the World is mostly unvaccinated so I guess it makes sense to keep the money tap fully on for the time being.

Please note that all the money supply graphs show percentage change year on year. So in the UK, money supply grew by 8.5% on May last year when it grew by 12%. Visually it looks like a reduction, when in fact its a lower growth rate on an already high base.

Having said this, if over the next 6 months we see the red line drop to 2-4%, it would suggest only small increases in base rate are required and the spike in inflation is temporary. We shall see.

THE IMPLICATIONS OF COVID FOR TAX RATES

The national debt of the major economies has increased significantly over the past year.

Federal government debt now stands at $28.2 trillion. In the current fiscal year, taxpayers have shelled out $319.9 billion in interest expense on all that debt after paying $522.8 billion in 2020.

Journalists do not seem to understand the truth - if the central bank finances the debt i.e. by buying Government bonds - then when the Government pays the interest it flows to the central bank and then back to the Government. IT IS NOT A CHARGE ON THE TAXPAYER.

The UK national debt is £2 trillion of which £0.9T is held by the Bank of England - so nearly half the interest bill is a closed loop within Government.

The Fed, the B of E and the ECB all pay interest received on Government bonds back to the Government. Effectively Government bonds held by central banks is debt relief.

However, because much of the population do not understand this, Governments will probably raise taxes using the cost of Covid argument. If they were honest, they would say we are raising taxes to pay pensions, and for health and social care all of which are costing more because of ageing societies.

The UK Government will launch a 'Social Solidarity' tax next March. It will raise £10Bn and is likely to be a 1% charge on employees and employers; effectively an increase in NI.

At the time of writing, it is clear the stimulus remains which means that there is enough new money in the system to finance inflationary wage growth of 5-6%.

This is what I expect to happen in the UK. CPIH will be running between 3% and 4% over the next 12 months. I suspect Boris will call an election in 18 months. Until then, expect only small increases in interest rates.

This will ensure UK house prices rise 5% over the next 12 months.

Currently, it is my belief that Governments and Central Bankers are trying very hard to ensure inflationary expectations do not become embedded in the national psyche, because once they are, it is almost impossible to rein then in without strangling the economy. An example of this was the inflationary period of the seventies which was caused by two factors; the first was a fourfold increase in the price of oil; the second was a significant relaxation of credit controls.

The blame is always laid at the trades union for negotiating above-inflation wage awards, but they were responding to inflation which was effectively imported and then financed by the commercial banking system.

In the early eighties, the UK Government was determined to kill inflationary expectations by reining in the Trades Union. In fact, the economy was strangled by North Sea oil, resulting in a significantly overvalued pound. Result? A collapse in manufacturing exports, unemployment soaring to over three million and labour bargaining power was reduced. This was more influential than legislation.

But yet again, restrictions on credit creation were reduced and by 1990 inflation was running at 10%. The collapse in Barclays and NatWest and 14% base rate in 1990 brought money supply down from 14% yoy to 2% yoy growth within a year. And the next ten years was a period of stable growth with a stable inflation rate.

What is the point of telling you this?

Inflation and expectations of inflation are both the result of excess money. There is currently excess money in the global system. Inflation is rising but as yet it is not embedded in the psyche. The next year will be crucial.

CRYPTOCURRENCIES

Money has three key functions. It is a medium of exchange, a store of wealth and a unit of account. $ and £ whether in electronic or paper form deliver this.

The most popular digital currency is Bitcoin. It has a market value of $700Bn, but a single tweet can knock off 40% of its value. It's an environmental disaster. Mining it uses electric power equivalent to the whole of Pakistan's electrical supply. And the blockchain software also uses significant computing power.

Central Banks worry that crypto will reduce their ability to influence the money supply and are considering creating their own crypto which would effectively be a digital representation of their own currency. If and when they do, I suggest cryptocurrencies will be mainly used for illicit trading and the dark web. You can no longer buy a Tesla with Bitcoin.

The price of Bitcoin on any one day shows extreme volatility.

Until central banks universally accept bitcoin in exchange for local currency, it's rôle will be limited. Currently 92% of Bitcoin is not actively traded.

So far, Bitcoin is not a very good store of wealth and a lousy medium of exchange. But it has been purchased by many, presumably alongside lottery tickets or even instead of them.

Central Bank digital currencies would be available to all and could be a very efficient low-cost payment system run directly by not for profit central banks.

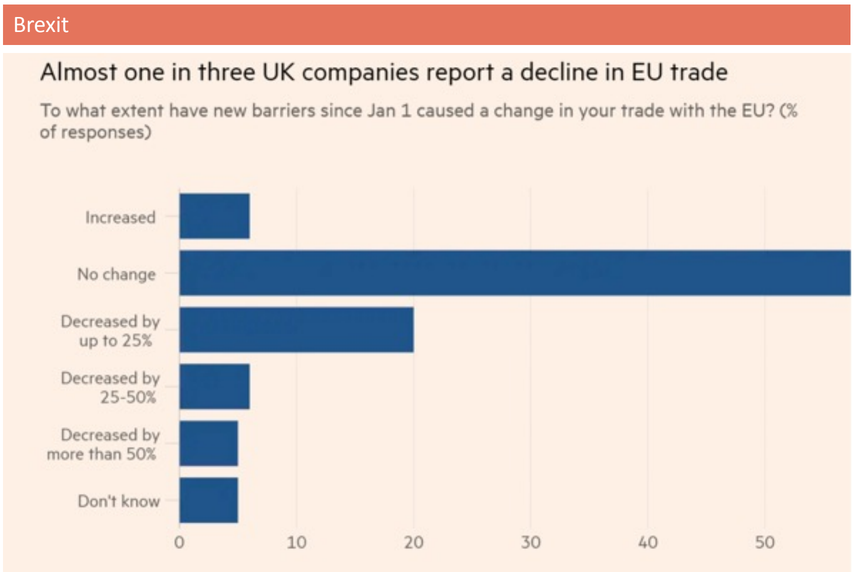
THE IMPACT OF BREXIT

The Covid stimulus plus lockdowns have reduced the impact of Brexit. 60% of companies report no volume impact from Brexit; 33% report reductions (but how much is due to EU Covid?) For many there are increased transaction costs and delays increasing the need for more more working capital.

Exports from the UK to the EU rose 9% in May.

Meanwhile, the unravelling of 40 years of legal constructs has only just begun. It will be years before we can say we have really left.

Whooooo boy



But the vast majority increased output per hour whilst working from home and it has been a challenge for SME owners to avoid employee burn out, which of course they are dealing with.

I am often asked is this a good time to invest? If the business owner can see an opportunity and believes the team can deliver, then it's always a good time to invest. There is no shortage of money, so now is a superb time to invest in growth.

The latest survey of CFOs shows their focus is on growth, not cost reduction. 77% expect to hire more, 71% are planning to increase investment spending, particularly on technology. And they expect to expand through M&A.

Assuming no more lockdowns, the stage is set for a period of inflationary growth. History tells us that Governments always allow the inflation genie to rise from the bottle primarily because it is improves the chances for re-election. Both the USA and the UK have leaders who have promised to deliver infrastructure renewal using the central bank money tree.

If you were thinking of selling your business, the next 18 months looks like the window of opportunity.

Finally the USA and the UK will enjoy higher growth and higher inflation than forecast. I will give you at least two years' warning of the end of the party!

EXCHANGE RATES

Brazil, Russia and China have all reduced their Covid financial stimuli. China has tightened do-mestic credit. However, the USA, UK and EU are all still in expansionary mode.

On balance the volume of US money creation implies a weaker dollar, but if the Fed changes its position and raises rates before 2023 then the opposite will happen. We await the outcome of the central bankers' conference next month.

The pound at $1.40, and 1.20 Euro looks sensible until September. Then we will have to see!

THE OUTLOOK FOR SMES

As I have said before, the success of the UK depends on the performance of businesses which have fewer than 200 employees. They produce 60% of our national income. They are mostly extremely adept at adjusting their business model to changing circumstances. This is because of can-do and must-do attitudes on behalf of owners and employees. I believe this is because of a short and direct link between customer satisfaction and what appears in the bank account.

I think Covid gave some employees the excuse to stay at home and when asked to return to work, they are the ones who will find themselves redundant in the Autumn when furlough is over.

Roger Martin-Fagg

JSA Consultancy Services

5a Wilmington Square,
London, WC1X 0ES
England
T: +44 (0)20 7688 1928
E: info@jsacs.com
W: www.jsacs.com

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!