ECONOMIC UPDATE APRIL 2023

At the end of November 2022, I concluded: The global economy is transitioning to normal. Transition is never smooth and will result in some countries doing better than others. My opinion is that the USA will be the least affected; the UK and Germany the most. Germany because of energy and the slowdown in China; the UK primarily because of moronic political decisions.

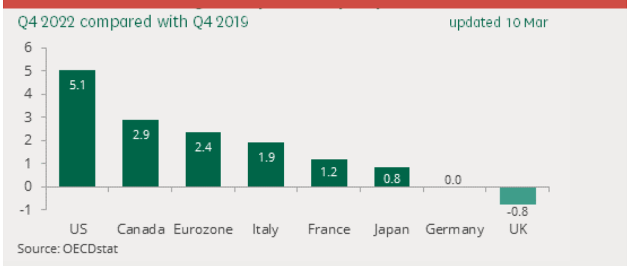
The good news is the Sunak cabinet might just deliver the stable platform business needs to invest and expand. Global growth in 2023 will just nudge 3% and the drivers will be the USA and Asia. The global inflation rate should begin to fall towards 3% in the third quarter of 2023. The UK will be higher at 4-5% because minimum wages will increase by 9.7% which is 9.4% above average productivity growth. Sterling is weak against the dollar and the trading costs due to Brexit will continue to put pressure on import prices.

In the UK, we have,at last, a Prime Minister and Chancellor who are doing the right things and the right wing of the party seems to be losing its influence.

In the USA, Biden is proving to be much more effective than his predecessor. His Inflation Reduction Act aims to stimulate investment in domestic manufacturing capacity, encourage procurement of critical supplies domestically or from free-trade partners, and jump-start R&D and commercialisation of leading-edge technologies such as carbon capture and storage and clean hydrogen. It is also allocating money directly to environmental priorities and is requiring recipients of federal funding to demonstrate the benefit to growth. The Congressional Budget Office estimates that the law will reduce budget deficits by $237 billion over the next decade. This is the third piece of legislation passed since late 2021 that seeks to improve US economic competitiveness, innovation, and industrial productivity. And it is attracting significant investment away from the EU, and to a lesser extent the UK.

The performance of G7 countries since just before pandemic. Please note the chart compares Q4 2019 with Q4 2022.

G7 real GDP% change compared to pre-pandemic levels



UK Q4 2022 was adversely affected by the Truss budget.

Taking annual GDP data, the UK performance is as follows:

2020	-11%
2021	+7.6%
2022	+4.4%

Economists are good at looking in the rear-view mirror, but not so good at reading the road ahead.

Many of my regular readers know I am what is called a monetarist. This means I believe the growth of money supply is an excellent predictor of nominal GDP growth. How much of that nominal growth is real and how much is just inflation is more difficult to forecast. It depends on productivity, which in turn depends on investment, training and attitude.

In 2022, nominal GDP grew by 9.5%. To calculate real GDP, the Treasury use an index called the GDP deflator. It is a complicated construct which tries to distinguish between price increases justified by product and service improvements (which are not deemed inflationary) and price increases with no change in quality, such as the increase in gas prices and most basic foodstuffs.

The deflator for 2022 is 5.09%. So 9.5%, deflated by 5.09%, gives a real GDP growth rate of 4.41% for last year.

In the Treasury Red Book which covers the budget detail I note that the forecast deflator for this year is 2.89% and the forecast for nominal GDP is 2.5%.

Nominal GDP, and its composition by income and expenditure, is important for understanding the behaviour of the public finances. For example, vat is levied on the nominal price of goods and services, so vat receipts are closely linked to nominal consumption spending. Increases in nominal investment also affect receipts by raising the use of capital allowances, thereby reducing corporation tax receipts in the short term. As a large proportion of public spending is set out in multi-year cash plans (public services, grants and administration, and capital spending) or linked to measures of inflation (including benefits, tax credits and interest index-linked gilts), it tends to fluctuate as a share of GDP when economic fluctuations cause nominal GDP to rise or fall. Nominal GDP is also the denominator when calculating fiscal aggregates as a share of national income, including those that are the subject of the fiscal targets.

This is a complicated way of saying the Treasury is always inclined to assume low nominal GDP growth so Ministers can be told there not enough in the kitty. Then, as if by magic, six months before the election, there appears an unplanned windfall which allows for pre-election tax cuts.

The Treasury is just the same as the Sales team of a company who will always be pessimistic when agreeing targets, but also expect to routinely exceed the target for bonus payouts.

Unless the outcome for nominal GDP is better than 2.5%, it means that our real GDP growth rate is budgeted at minus 0.3%.

WHAT CAN WE EXPECT?

We start with money supply.

There is a lag of up to 18 months between changes in money supply and nominal GDP. Recent data shows money supply growing at the normal rate of 4% yoy. This suggests at the end of 2023, a nominal GDP growth rate of 4% is likely. The Treasury has assumed 2.5%.

I do not know what the Treasury view is on the impact of the huge increase in household bank deposits which took place during lock downs. The cumulation is around 180 Bn. Most of it, in the accounts of the top 20% of the population. Yes, inflation has eroded its purchasing power by circa 25Bn, but there is still a big chunk of spending power available.

Quite a few people have told me that they have lost some of this money to the taxman. OK, it leaves the individuals' accounts, but not the system, ending up in the account of a Government employee or supplier of goods and services to Government.
Also, about 20Bn has gone into property directly or via the Bank of Mum and Dad. 66% of parents have forked out an average of 33k for house purchases.

The Bank of England was planning to withdraw 80Bn this year, but they delayed that following the Truss debacle.

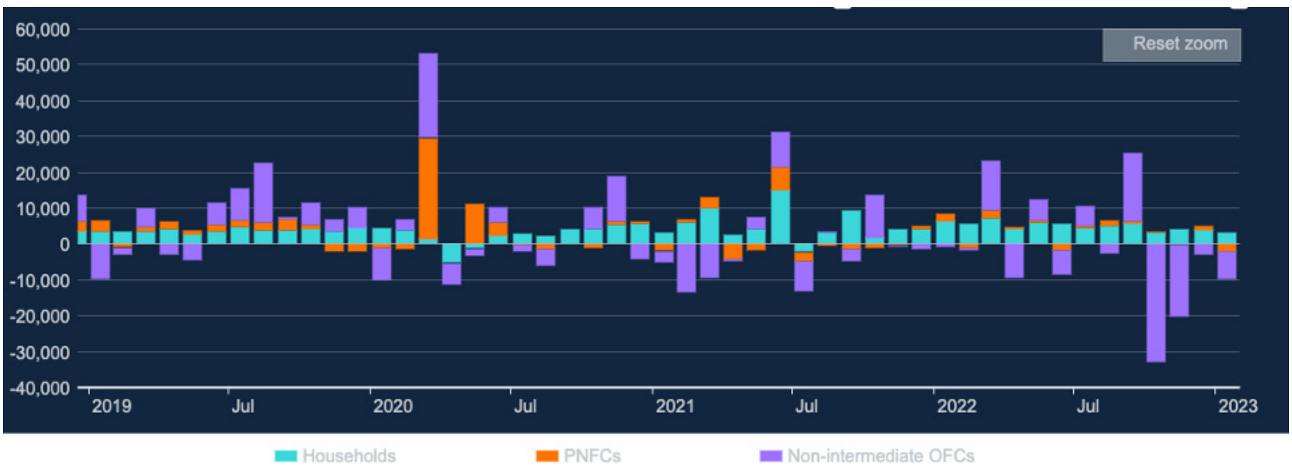
The amount going into to our economic pipe is growing by 4% which is 9Bn a month. If households draw on their savings, then Nominal GDP will be growing faster than 2.5% this year.

The light blue bar is the change in household money balances; the orange bar is businesses, the purple bar is insurance companies and pension funds. Note, in September last year they gained a lot of cash by selling gilts. And in October and November, they bought the gilts back. Note too that in January this year, business accounts (PNFCs) reduced as they paid their taxes.

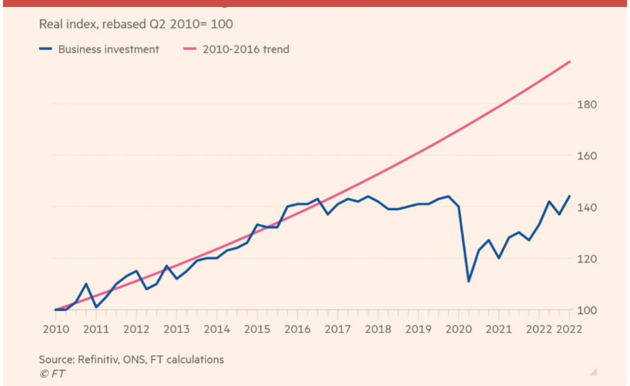
SO WHAT DOES MONEY SUPPLY DATA TELL US?

Firstly, the inflation rate will fall rapidly; secondly, with stable, competent Government plus the 100% Capex allowance announced in the Budget, business investment should surge; thirdly there is no case for further increases in base rate. But the Bank has moved it to 4.25%. Why?

Nominal and real GDP growth could turn out better than forecast and because of the chronic underinvestment since 2016 the full capacity constraint is likely to kick in when real growth hits 1.3%. In simple language the Bank thinks the recovery will be strong in the second half and this will maintain inflationary pressure via wage demands.



UK business investment growth has stalled



Currently 22% of adults are economically inactive. They are neither working nor looking for work. They are students, early retired or long-term sick. There are 9 million of them.
The Treasury knows that GDP growth would be higher if more of these were active. The budget is targeting the early retirees and the long-term sick. Getting say 2 million new producers would enhance our feeble GDP prospects, particularly if combined with higher levels of investment spending.

The gas price chart, when combined with money supply (and the accumulated cash in households' accounts) suggests a strong second half to this year.

The price of gas continues to fall. This will be reflected in household bills in 3-6 months time. And it could be the driver of a second half well ahead of expectations as households release savings.

I must be clear. I am at top-end of optimistic.

I expect nominal GDP to be growing at 6% at year end. I expect inflation to be between 4.5% and 5%, so real growth between 1% and 1.5%

Why? In my opinion business owners have been waiting patiently for signs of a mature Government taking decisions which are more than just to produce positive sound bites. If you look at the list over the past three years, it is lengthy. And none of it has been delivered, primarily due to revolving ministers. Sunak and Hunt are showing they will create a stable platform to stimulate investment. And hopefully, they will extend the 100% investment allowance beyond 2026.

Money plus optimism creates growth.

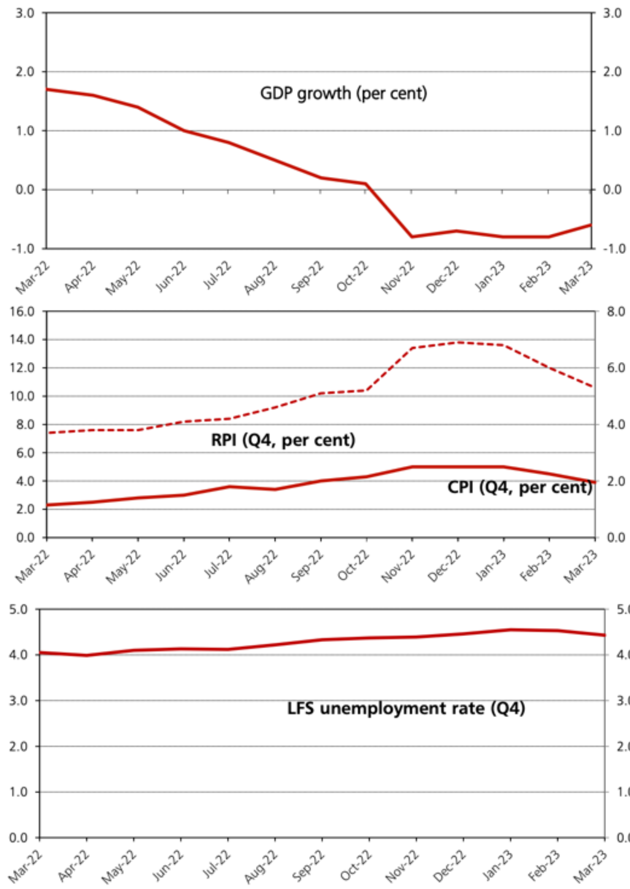
So, the second half of this year is expected to be better than forecast. This performance will come from retail, and investment spending. But inflation will be between 4% and 5% Wage growth in booming sectors will be 5-10%; the average including the public sector will be 5%.

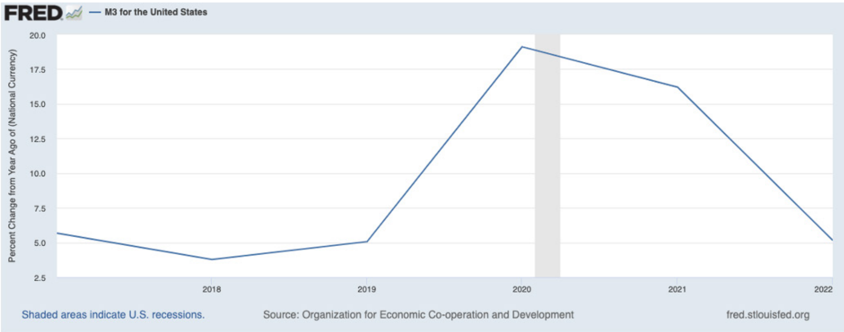
The media is full of the cost-of-living crisis, the banking crisis, the housing crisis. *The definition of crisis: a time of intense difficulty or danger.*

There is a crisis for some on minimum wage and renting; there is most certainly not a banking crisis. Truss created a mortgage crisis but that is now over, and there isn't a housing crisis. The NHS is facing significant challenges; but I would not use the word crisis.

Here is the collective view of mainstream forecasters when the budget was being created.

Average of independent forecasts for 2023:
GDP growth, CPI and RPI inflation and unemployment





We start with money supply. It's back to pre-covid growth rate. But the surge during covid significantly increased US bank balances. During covid, US Banks used their depositors' money (much of which had come from the $5Trn covid support) to buy US Government Bonds. However, Silicon Valley Bank directors were very keen to earn huge bonuses and so took bigger risks with customers' money. They bought what were effectively sub-prime bonds because the yield was higher than US Treasuries. It triggered their bonuses. However, when the Fed began to raise interest rates, the price of these bonds fell significantly and SVB had to charge the losses to their Tier 1 capital, wiping it out. The bank became insolvent. But the directors all still have their bonuses. It felt like a repeat of 2008 and Twitter traffic began to create worries. Which other banks could be in danger?

Credit Swiss was known to be weak due to a CEO who always knew best. It survived 2008 pretty much unscathed but as other banks changed their systems and work practices, CS did not. And herd behaviour, prompted by Twitter exchanges, resulted in a run on the bank. 111Bn SF was withdrawn.

An off-the-cuff comment by the chair of the Saudi National Bank, by now Credit Suisse's largest shareholder, about refusing to invest any more into the group — combined with jitteriness over the recent collapse of three US banks — was enough to finish the business off.

The Swiss Government facilitated a takeover by UBS. Meanwhile, investors in CS lost 17bn.

This will not cause a global crash as happened in 2008. But it underlines the core problem of banks. They are highly leveraged. This is possible because central banks will always intervene to prevent a collapse (unless the banks are a tiny part of the system as is SVB) On average, 25 banks fail each year in the USA, including small local banks serving farming communities. Their size means they are below the regulatory radar.

Large US banks are closely watched, unlike the small ones. In the UK, all banks are closely watched by the Bank of England.

Let's look at NatWest to illustrate a typical large UK bank's balance sheet

Nat West Group (£m)

Loans	373,479	52%
Cash	144,832	20%
Bonds	30,895	4%
Other	170,847	24%
Total Assets	720,053	100%
Equity	36,496	5%
Loan Capital	58,585	8%
Deposits	470,759	65%
Other	154,213	22%
Total Liabilities	720,053	100%

Total balance sheet leverage is 20X; loan book leverage is 10X. By way of comparison, a UK mutual building society is only allowed to leverage 3X.

Equity is the core capital, or Tier 1, as it's called. The Bank of England requires UK banks to have 4-5% of their total balance sheet supported by Tier 1. If there are losses on the asset side of the balance sheet, these are charged to Tier 1. Indeed a U.K. bank is required to make provision for expected losses on loans and they are required to revalue their bond holdings regularly by marking them to market. NatWest has enough capital to cover 10% default on its loan book.

The majority of its loan book is mortgages. Currently there are 75,000 UK households in arrears, out of a total of 10.5 million so not much risk there. No charge to core capital is required until day 91 in arrears is reached. The risk to NatWest is much more likely to be the zombie businesses still on its books. However, given the collateral usually expected, actual losses are likely to be small. We can safely conclude that a repeat of 2008 is extremely unlikely.

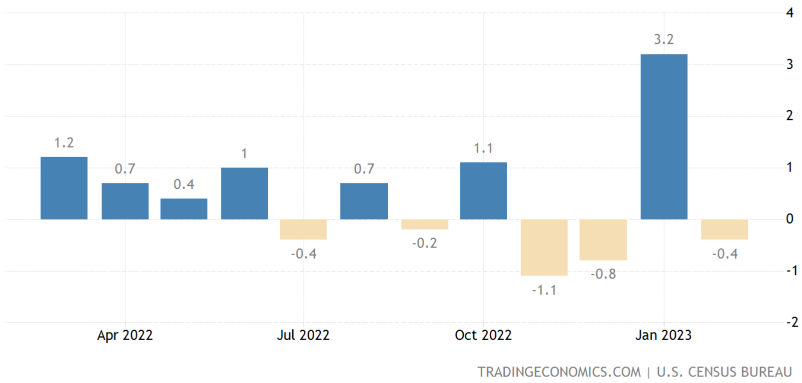
The Swiss however have upset the markets. Banks' Tier 1 capital is equity. However, there is a financial instrument called an Alternative Tier 1 bond. This is a bond with no expiry date and a generous rate of interest - circa 7-10%. It is part of Tier 1 capital and easy to raise from the market. To sell Credit Swiss to UBS, the Government decided that the AT1 bond holders should lose all their money - 17bn SF - before shareholders. That broke a sacred principle which is that bond holders rank ahead of shareholders – i.e. any proceeds of the sale of a defunct business will go to them, before shareholders. This has caused a flurry of activity on social media with hedge funds shorting banks and magnifying the so called problem.

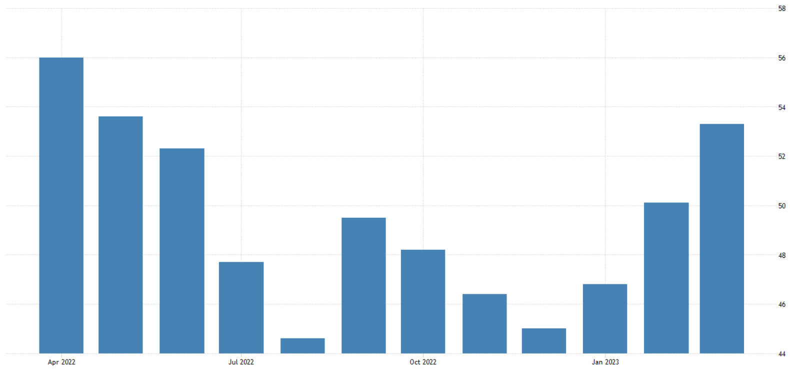
Both the ECB and the B of E have stated clearly that the principle of bond holders before equity holders remains sacrosanct in any failure. But the Swiss have created jitters and all banks are now under close scrutiny, starting with Deutsche Bank. The price of AT1 bonds has collapsed by 30%. The reputation of the Swiss as competent bankers and regulators has been trashed.

Returning to other aspects of the US economy.

RETAIL SALES

February retail sales volumes reflected the weather. At the beginning of February, 51% of the country was covered in snow; by 17 February, it was 42%; by 23 February it was back to 45%, and at the end of the month, 28%. Given the weather, sales held up well! I guess the malls were the warmest place to be.



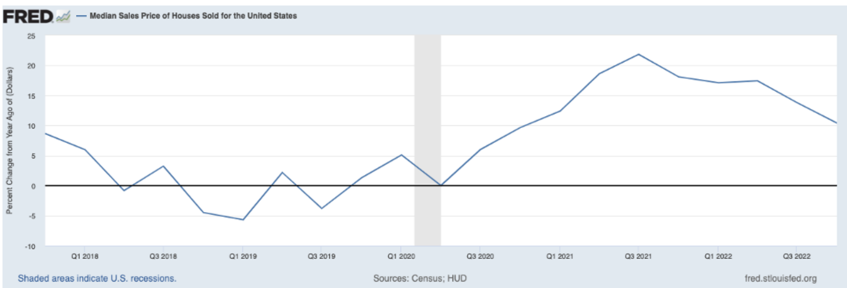


The Composite PMI shows recovery; any number above 50 is positive for growth in GDP.

Foreign Direct Investment	2019	2020	2021
FDI Inward Flow *(million USD)*	225,108	150,828	367,376
FDI Stock *(million USD)*	9,362,942	10,813,507	13,619,023
Number of Greenfield Investments*	2,015	1,641	1,671
Value of Greenfield Investments (million USD)	101,210	67,161	85,936

Source: UNCTAD, Latest available data.

Here is the evidence that the Inflation Control Act is delivering. Japan is the No 1 investor in the US followed by Canada, Germany and the UK. I expect the USA to be the best performer in G7 growing by 2% this year. Again, this is above mainstream forecasts which averages 0.5% real growth.



As in the UK, house price growth is the core driver of the average household's wealth, and prices were still rising by 10% third quarter of last year.

The 30-year fixed price mortgage is currently 6% and average selling prices are now flat, with falls in some cities.

But real incomes have grown 4% since 2020. Real median household income is currently $71,000 and an unemployment rate of 3.6% will ensure income growth.

In sterling, US real income is £51,000. By comparison the UK is £32,000. Real incomes were static from 2016 and are now falling by 2%.

Simply put, the USA is running hot and the UK lukewarm!

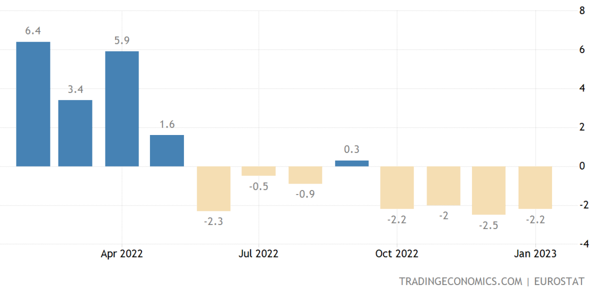
However, we should not forget the USA is effectively 51 different countries, Connecticut median household income is $84,000, Alabama $51,000.

The EU

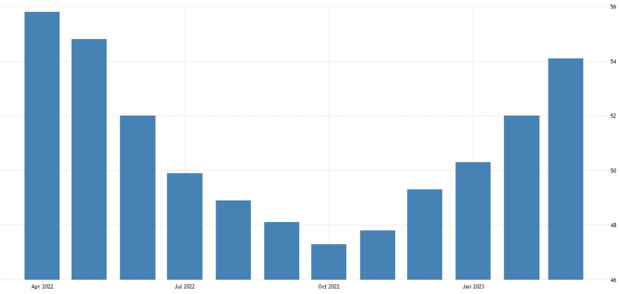
As we all know, the EU is a mixed bag of big and small, rich and poor countries. The biggest and richest is Germany. Money supply data is now aggregated for all the member states which is annoying when we want to look at individual countries.

The chart shows M3 growing at 4% the same as the UK but below the USA at 5.2%. This is why inflation rates will be falling rapidly from June onwards.

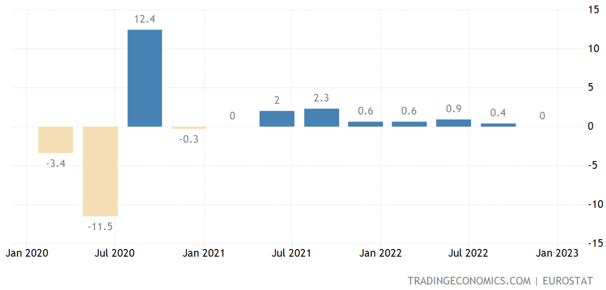
EU Retail sales data again mirror the UK but not the USA.



And the Composite PMI shows a rebound in business order books.



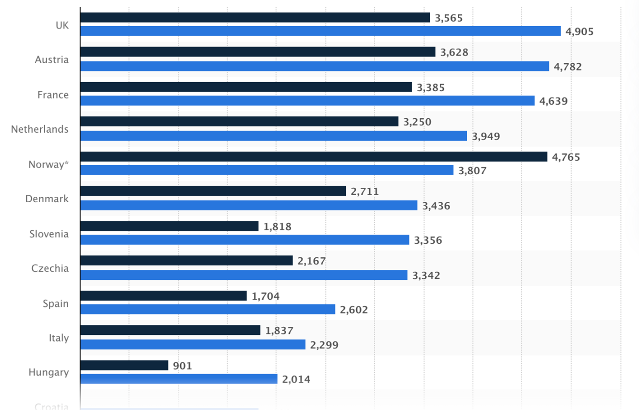
EU growth rate is weak but is expected to pick up in the second half of this year



HOUSE PRICES

The chart shows prices per square meter in euros. The black line is existing stock, the blue line new build.

It shows us the UK is the most expensive for new build; Norway for existing stock. In aggregate, the growth rates in prices have been similar in the Western World as Covid support money quickly found its way into real estate.



TRADE BETWEEN THE EU AND THE UK

Since Brexit the UK media have reported less on the EU apart from the Telegraph which keeps telling its readers the UK is doing better than the EU (which is false).

The EU is the UK's biggest market (the USA is second). 42% of all UK exports go there and 45% of our imports are from there. We have a trade deficit of circa 30Bn with the EU. Northern Ireland followed by Wales and the North East of England had the highest percentage of goods exports going to the EU of all the countries and regions in the UK in 2021.

Northern Ireland followed by the South East of England, had the highest proportion of goods imported from the EU. Under the terms of the UK-EU Trade and Cooperation Agreement (TCA), the UK is no longer a member of the EU single market and customs union, though the provision of the TCA do not apply to trade in goods between the EU and Northern Ireland.

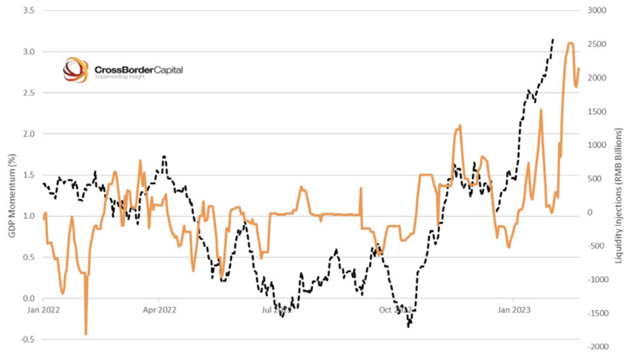
It's an imperative that the UK builds stronger and deeper links with the EU if we wish to prosper.

There are signs at last that the Government recognises this, and the NI protocol will, I hope, lead to us rejoining the EU Horizon research group.

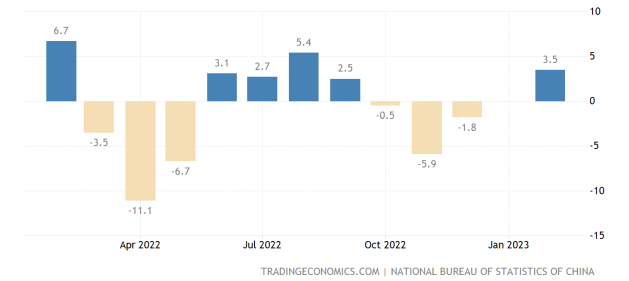
The much-vaunted trade agreement just signed with Pacific rim countries will add 0.08% to real GDP growth over the next ten years. It is true these countries are expected to grow faster than the EU but the UK specialises in high-end products (i.e. expensive) and services. Both of which are bought by countries with already high per capita GDP ie the USA and the EU.

CHINA

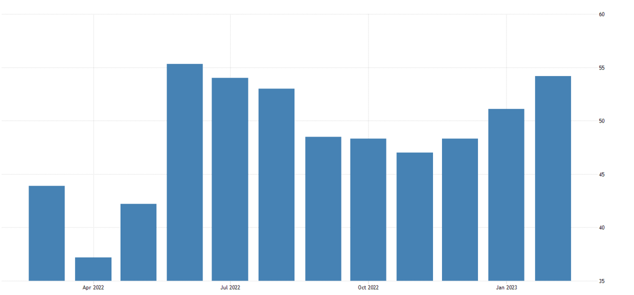
The chart shows the QE carried out by the Bank of China in orange, the GDP growth rate is the dotted line. Over the past year the stimulus has been $3.5 trillion which is producing a strong recovery. The West has slowed its money supply growth back to 4-5%, China has pumped theirs up. This is reflected in retail and the PMI.



China retail sales



China composite PMI



Trade as a % of GDP in China is 37% (the UK is 57% and the USA 25%) This is a point which is fundamental and forgotten. The UK depends on trade to a much greater extent than China or the USA to enable growth.

The PMI shows recovery in China is gathering pace due to the significant stimulus. Xi knows that China is increasingly self-sustaining (apart from still needing to import raw materials and knowhow).

This is reflected in their growing self-confidence on the world stage. Biden's America First, plus reshoring in the EU probably doesn't worry China that much. And Xi's anchored belief that China has a superior system of Government which will in the end allow them to dominate the World is intact.

NOW THE BIT YOU HAVE ALL BEEN WAITING FOR, MY SCHOOL REPORT!

In February last year I made these forecasts. The actuals are in brackets

Real GDP	+3.5%	(4.4%)
Nominal GDP	+9.5%	(9%)
Wage growth average	+6%	(6%)
Inflation Rate average for the year	+6%	(10%)
Unemployment by end of year	4%	(3.7%)
Base rate by end of year	+1.5%	(+4%)
Average house price	+6%	(+10%)
Exchange Rate	$1.35 Euro 1.20	($1.24 Euro 1.13)

Not a good result. I have been considering a career change. I have applied to be Liz Truss' economic adviser. Should be a good fit!

So, forecasts for end of 2023

Real GDP	+1.5%
Nominal GDP	+6%
Wage growth	+5%
Inflation rate	+5%
Base rate	4.25%
Average house price	+0%
Unemployment	4%
Exchange rate	$1.26 Euro 1.15

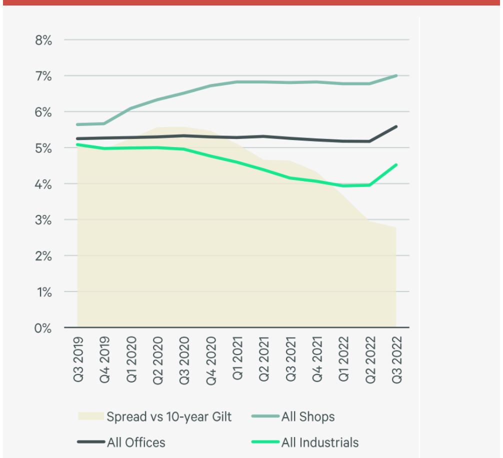
FINALLY LET'S TAKE A LOOK AT PROPERTY

We begin with Commercial Real Estate (CRE). The way CRE works is pretty straightforward. Investors have choices. There are equities, bonds and property.

The price of CRE is closely related to the yield on Gilts. Both asset classes give a return which is a combination of income and capital. The yield depends on the relationship between income and price.

When the Bank of England increases base rate, the price of existing Gilts falls, increasing their yield . The same thing happens with the price of CRE. Look at the chart.

Trends in prime yields, 2019-2022



Source: CBRE Prime Rent & Yield Monitor

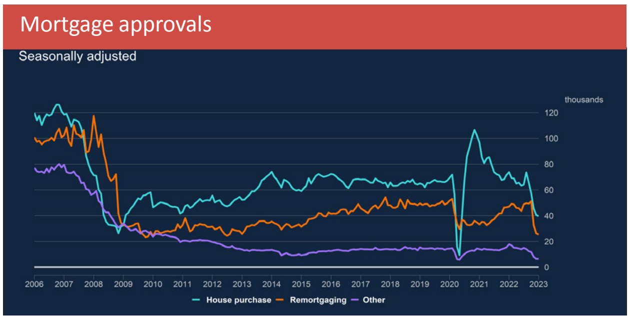
The difference between CRE yield and the ten-year Gilt yield known as the spread was considerable because the Gilt yield was so low, thanks to QE. In Q3, 2022 things changed. The Truss budget caused Gilt yields to soar, the spread narrowed, and CRE prices had to fall to increase yield and maintain its attractiveness as an asset class.

The spread is now returning to normal (around 2%) and CRE yields will stabilise. The outlook depends on rental growth as the driver of return rather than capital growth. Legislation, the green agenda and hybrid working will all require increased investment in existing assets. And rental growth will depend on real economic activity which is constrained by labour supply. So the conclusion is a spread of about 2% over 10 year gilts which means a return of circa 5%.

THE HOUSING MARKET

The latest data shows average prices are 2% higher than last February. Transaction volumes have fallen 10% to 90,000 a month. This has happened because mortgage providers were spooked by Truss and mortgage supply collapsed in the fourth quarter of last year. The average price of a two-year fixed 75% loan to value is now 4.8%, and this is unlikely to go higher.

I expect buyers to return to the market in the middle of this year and transaction volumes to increase by 5,000 a month. I do not expect average selling prices to fall.



CONCLUSION

The outlook for this year has improved significantly since last November. For the UK, confidence is rising because Government is beginning to make sensible decisions. For the World, the return to growth of China and the USA will impact on the EU, in particular Germany. I think base rates are unlikely to increase. But neither do I expect much reduction from current levels. Falling energy prices will boost household real spending power.
The money which accumulated during Covid will begin to flow into both consumption and investment.

Western economies are still close to full employment so inflation rates will not return to 2% or less and interest rates will therefore remain close to current levels.

The rule of thumb established over 200 years is that the correct rate of interest is the real GDP growth rate, plus 2.5%, when central banks are not trying to stimulate or constrain activity.

So, for the UK between 3.5% and 4.5%
For the USA, between 4.5% and 5.5%

The fundamental issue is confidence which, these days, is almost immediately shattered by the spread of inaccurate facts by social media and mainstream media misusing language, particularly the word crisis. Crisis means a period of intense difficulty or danger. It is fair to describe Covid as a crisis and Eastern Ukraine has been in crisis for a year. The Truss budget was a crisis for the bond market.

But there is not a housing crisis, a banking crisis, an NHS crisis, or a Northern Ireland crisis; just a lot of issues which can be resolved with commitment and hard work.

I assume most of my readers run businesses. You will know that, most of the time, that requires continuous, energetic application and attention to detail. The satisfaction comes from the outcome, not the effort.

For individual businesses, increasing productivity is key. And the solution is a mixture of AI, capex, training and development, and cultural change. Step changes are difficult to achieve but small, incremental changes, month after month, do work.

All Government needs to do is sort out the infrastructure, education, health, social care, defence, trading relationships and an overly complicated tax system. And avoid micromanaging at the business unit level.

Just create a stable environment with no big surprises, and let entrepreneurs get on with it!

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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!