ECONOMIC UPDATE JUNE 2023

If I arrived on the earth from another planet and knew nothing of Covid, Trump, Truss, Sturgeon, Boris or Putin whilst considering the macroeconomic data for the G7, I would be close to certain that the G7 would be in recession in 2024.

But I have been around a long time, and seen the economic events of recent years. All is not as it seems. In this update I will try to explain what the data is telling us, and give an opinion on the likely outcomes.

We begin with the difference between monetary policy and fiscal policy. Monetary policy is setting interest rates to influence the behaviour of commercial banks and their customers. Interest rates are raised to reduce the demand for loans, and hence the growth rate in the money supply.

Lower growth in money supply primarily affects the price of real estate in all its forms, which, if falling, hits household confidence, and those with mortgages who find upon renewal that their discretionary income is significantly reduced.

Fiscal policy is primarily changing tax rates and Government spending to redistribute income from those in work, to those retired. And to fund infrastructure, health, defence and education. And, exceptionally, to support employment and business owners during a pandemic.

The problem is that fiscal and monetary policy are not independent of each other. During Covid, there was a massive expansion in Government debt, all of which was financed by the central bank. So Covid drove both expansionary fiscal and monetary policy.

The expansion was $17 trillion globally, of which $900 bn was in the UK. The inevitable result has been a surge in average price levels of everything, including land, buildings, labour, materials, food, energy, IP, equities.

However, G7 Governments are currently expecting their central banks to bring inflation down, whilst fiscal policy still remains expansionary. Fiscal policy is expansionary if Governments are running budget deficits.

Currently, the UK Government is spending £45bn more than its income from taxes. The USA is spending $1.5 trillion more. And their central banks are raising interest rates because excess demand is causing inflation.

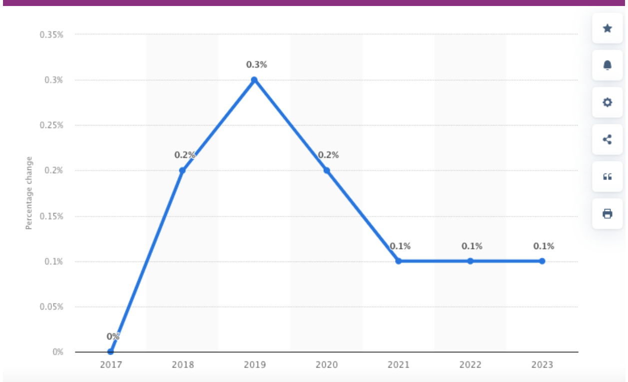
So Government has its foot on the fiscal accelerator while the central banks are on the monetary brake. No wonder there are mixed signals from business owners and their customers.

Imagine you are driving a car, you have your foot on the accelerator; your passenger their foot on the brake………how fast forward will the car go, if at all?

If the UK Government seriously wanted inflation back to 2% asap, they would raise income tax by 5p, create a recession and prices (after a time lag) would stop rising (except for imported products). Or cut Government expenditure by up to £45bn. Neither of these actions is, of course, politically acceptable. So we are left with the hope that higher interest rates will do the job without causing a recession.

The core U.K. problem is a lack of productive capacity. The output gap is an estimate of how much spare capacity there is in the economy. It's currently estimated at 0.1% of GDP. This means that, overall, the UK has virtually no spare capacity.

Forecast UK output gap 2017 – 2023



Up until 2008, the average real growth rate for the UK was 2.3%; between 2008 and 2016 it was 1.3%; since 2016 it has been 1.1%

Our productive capacity has barely grown since 2016, due to a collapse in investment, plus demographics.

The key question is - can the UK grow faster than 1.1% per annum without inflation running above 2%?

The answer is no.

This is why.

If Governments are serious about taking inflation back to 2% as soon as possible, they must reduce demand. We cannot 'magic up' more labour supply. Investing in capacity creation takes time and simultaneously increases the demand for labour, which isn't available.

A recession would drive out zombie businesses, creating more resource for others. We know this is not current Government Policy. So all the emphasis is placed on Monetary Policy. Currently money supply is growing at 3.2%. This could, in theory, finance 1% real growth and 2% inflation by the end of next year. And this is in line with the belief of many forecasters.

So there is no need to raise interest rates beyond the current 5% unless wage awards still run in excess of 5%. However, regular pay in the first part of this year was up 7.2%. UK productivity is currently estimated at 1.3%. So arithmetically, we are looking at core inflation running at 5-6%. Therefore the 2% inflation rate target is unrealistic.

Next year, real GDP could be minus 2% or plus 1%. I expect plus 1%. Why? Because although new money is running at 3.2%, we still have Covid support money in the system. Around 125Bn. This would be sufficient to finance 5% inflation, plus 1% real growth, even if money supply fell back to 2% growth.

If Government presses the B of E to hit the target of 2%, I can see 6% base rate and a 2 year recession. Bluntly, we need unemployment to be around 7% to ensure employers can pick from a stock rather than poach from others. Even then, there will still be wage inflation in Fintech, IT, and high-end engineering.

Over the next ten years our home grown labour supply will manage to expand by about 200,000 a year. This year it will grow by 500,000.

Unless there is significant immigration, our growth rate can only exceed 1.1% if every business has a mission to automate, and implements it quickly. This is effectively 'needs must'.

AI AND AUTOMATION

How good is AI? Can it deliver the required productivity gains? I used Chat GPT to summarise our discussion so far. I cannot find fault with it.

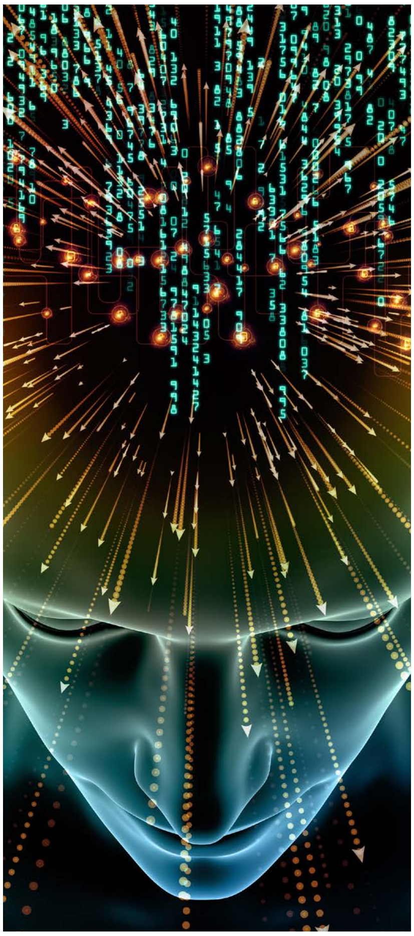
It is important to note that while governments can influence inflation, there are also external factors such as global economic conditions, commodity prices, and market expectations that can affect inflationary trends. Therefore, controlling inflation is often a complex task that requires a combination of prudent monetary, fiscal, and supply-side policies.

AI is a supply side component and so I asked Chat GPT to give an overview of supply side technologies. This is its response:

As of my knowledge cutoff in September 2021, here are some of the latest productivity-enhancing technologies that were gaining traction:

1. ***Artificial Intelligence (AI) and Machine Learning (ML):*** *AI and ML technologies are being applied to various areas to automate tasks, optimize processes, and provide intelligent insights. They can assist with data analysis, customer service automation, predictive analytics, and more.*

2. ***Robotic Process Automation (RPA):*** *RPA involves using software robots to automate repetitive and rule-based tasks. It can significantly reduce manual effort and increase efficiency in areas such as data entry, invoice processing, and HR onboarding.*



3. ***Internet of Things (IoT):*** *IoT enables the connection of physical devices to the internet, allowing data collection, monitoring, and automation. This technology has applications in smart homes, industrial automation, asset tracking, and energy management, among others.*

4. ***Cloud Computing:*** *Cloud computing offers scalable and on-demand access to computing resources, eliminating the need for on-premises infrastructure. It enables organizations to store, process, and access data and applications more efficiently, leading to increased collaboration and productivity.*

5. ***Collaboration Tools and Project Management Software:*** *There are numerous tools and software available that facilitate team collaboration and project management. These platforms enable remote work, real-time communication, task tracking, document sharing, and seamless coordination among team members. Virtual and Augmented Reality (VR/AR): VR and AR technologies are being utilised in various industries to enhance productivity. They provide immersive training experiences, virtual meetings, remote assistance, and interactive visualisation for design and simulations.*

6. ***Wearable Technology:*** *Wearable devices, such as smartwatches and fitness trackers, can help individuals monitor their health and activity levels, manage schedules, receive notifications, and access information on the go. These devices can contribute to improved personal productivity.*

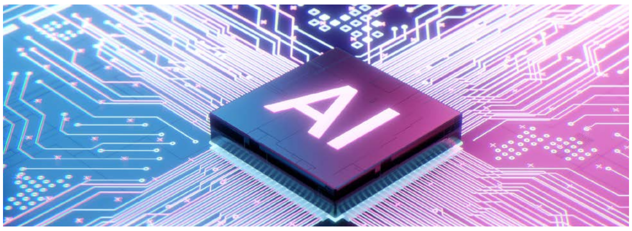
7. ***Automation and Robotics:*** *Industrial automation and robotics continue to advance, streamlining manufacturing and logistics processes. Automated systems and robotic machinery can handle repetitive tasks, leading to increased productivity and precision.*

Please note that technological advancements are continually evolving, and new productivity-enhancing technologies may have emerged since my knowledge cutoff in September 2021.

This is a good example of how AI has increased my productivity. I would normally spend the best part of a day scanning the web for the data in italics. It took 3 mins.

We know that since 2021 further advances have been made in automation of health care, drug design and back office processes.

Proponents of AI argue for its potential to solve big problems by developing new drugs, designing new materials to help fight climate change, or untangling the complexities of fusion power. To others, the fact that AI's capabilities are already outrunning their creators' understanding, risks bringing to life the science-fiction disaster scenario of the machine that outsmarts its inventor, often with fatal consequences.



The degree of existential risk posed by AI has been hotly debated. Experts are divided. In a survey of AI researchers carried out in 2022, 48% thought there was at least a 10% chance that AI's impact would be "extremely bad" (e.g., human extinction). But 25% said the risk was 0%; the median response put the risk at 5%. The nightmare scenario is that an advanced AI causes harm on a massive scale, by creating poisons or viruses, or persuading humans to commit terrorist acts. It need not have evil intent: researchers worry that future AI may have goals that do not align with those of their human creators.

My opinion is that AI is the solution to the labour supply shortage in the Western World. It will enable productivity growth, and thus expand the tax base which will be required to support health and wellbeing of the aged.

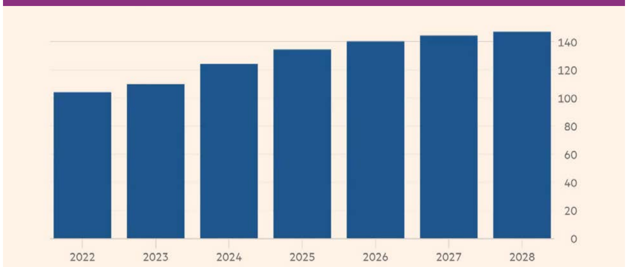
THE USA

Inflation is now 4% Wages are growing by 4.3%, so real incomes are improving. Base rate is 5.25%, so the real cost of money is positive, unlike in the UK, where the real cost of money, based on base rate, is around minus 4%. All US mortgages are fixed for at least 10 years and most are fixed for 30 years. So higher current interest rates only affect new mortgages. The US property market is less vulnerable to rate changes compared to the UK.

Even so, in the UK since 2014, any borrower would have shown they could maintain their lifestyles if rates rose by up to 3%. The 3% has been breached in the past two months.

Money supply growth is minus 5%, primarily due to the Fed's unwinding QE. Bank lending is growing by 1%. This data suggest the USA will slow, but thanks to the big federal deficit, the USA will avoid recession.

State pension spending is expected to rise by a third over the next five years



Fiscal years ending in March of year shown
Source: OBR
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THE EU

The Euro area inflation rate is 7%, base rate 3.75% so, as in the UK, the real rate of interest is still negative, and with wage growth at 4.4%, real wages are falling. The data suggests that in the last quarter of 2022 and first quarter of this year, the Eurozone shrank by 0.1%. Which, frankly, is neither here nor there, and well within accepted statistical error.

THE OUTLOOK FOR INFLATION

In the past 12 months, energy prices have fallen by 33% (oil); 60% (gas). Food commodities are around 33% higher, except for wheat which is down a third. Metals, except iron ore, are still rising. But steel is back to pre-Covid prices.

Labour produces output. The share of the added value it creates is shown in this chart.

Taking the nation as a whole, those who do the work get around 60% of the value created. The owners - i.e shareholders and landlords, get 40%. Demographics in the U.K. is a driver of this shift.

By definition, those who are retired are living off rents and Government tax transfers from those working. By definition, anyone on state benefits is living off the work of others.

The UK needs more producers and fewer recipients of money from the efforts of others.

HOW TO DO THIS?

Raise the retirement age, cut state benefits to the bare minimum for survival. Increase taxation on capital gains, including on property.

The politics of this distribution is - Labour would like to increase the worker %; Conservatives the shareholders/landlord %.

Since the eighties there has been a shift in the U.K. We have an increasing number who live off the ownership of assets, and a reducing number of those who live by producing.

In other words there are more inhabitants of working age choosing to receive income from having property and shares rather than from producing. To grow an economy we need more doers and fewer 'owners'.

This will require a significant societal shift which I do not think will happen. That is, until the rentiers no longer can survive on the income from owning, and then have to start doing!

The fact that 100k of the 600k early retirees are back producing may be just the beginning.

THE PROPERTY MARKET

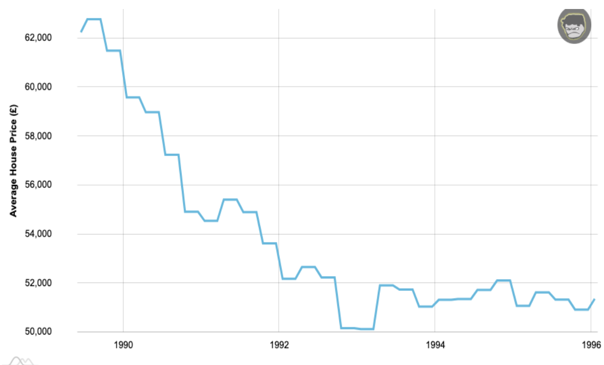
Monetary policy is concerned with using interest rates to influence the supply and demand for money. Currently, the supply of money growth rate has dropped to 3.2% yoy. This is because both the demand for, and the supply of, mortgages has softened, and banks are more cautious about lending to business.

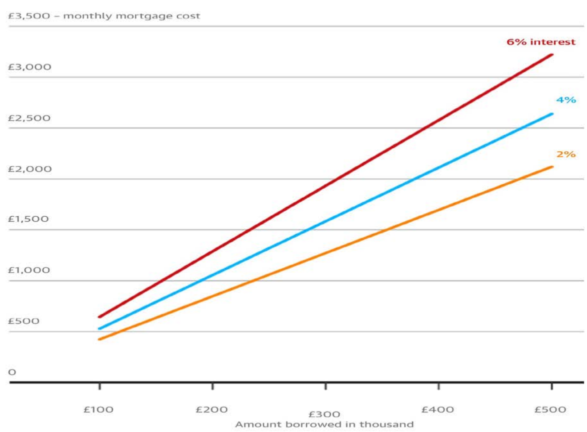
In the literature on the impact of higher interest rates, economists talk of inflationary expectations and argue that rising interest rates and expectations of further increases should moderate wage demands. In a tight labour market, the opposite seems to happen. Employees, particularly if changing jobs, will demand higher wages to cover their mortgages, and desperate employers pay up. The increase is then put on their selling price, thus maintaining, rather than reducing inflation. All the evidence suggests that inflationary wage demands only moderate when the supply of jobs falls – e.g. a sharp reduction in order books.

Can higher interest rates deliver a slowdown, or worse, a recession? The so called money transmission mechanism is much debated but the consensus is that it primarily works via the housing market.

The thinking is this: Most Brits hold their wealth in their primary residence. It gives them a place to live and a tax free capital gain. Ever-rising house prices increases perceived wealth and confidence that the country is doing well. There is evidence that if property prices are increasing, consumer confidence moves in line and spending flows.

And this can work in reverse, it did in the early nineties
Inflation in 1990 was just under 10%, base rate was 14%, so typical mortgage was 16%; wages were growing by 10.6%. Unemployment was 5.6%. House prices were falling by 1.5%
By 1992, unemployment was 10%, base rate hit 15% and the UK left the ERM. Inflation was 3.2%. House prices were flat. having dropped 18% in two years.





Many journalists are suggesting that there will be a repeat of the early nineties. However they have missed a key component.

The collapse in prices in 1990-92 was primarily because Nat West and Barclays were insolvent and calling in loans, pushing firms out of business and repossessing 300,000 homes, which they dumped onto the market, willing to accept any price, so long as it covered the debt.

A headline last week trumpeted repossessions up 50% in Q1. The number 750.

I strongly believe that we will not see a repeat of the nineties.

Firstly, UK banks are well capitalised, they have enough capital to cover delinquent borrowers without repossession. So there will be no auctions of repossessed properties to depress average prices.

Secondly, the labour market is much tighter that in the early nineties and any increase in unemployment will not push it above 5%

Thirdly, average earnings are up 7.2%, and will still be rising by 5% at year end.

Fourthly, energy bills will be lower than expected in the autumn

Fifthly, there is still 125Bn of excess deposits in the bank of Mum and Dad

Most importantly, 80% of mortgages are joint. So presumably two incomes, both of which are likely to be going up 5-10%, depending on job and location. 8.8 million were earning at least £52,000pa in 2022. 9 million households – just 30% - have a mortgage. At the end of 2022, the monthly average mortgage payment was £2000 per month. By the end of this year it will be around £2300 a month. The average mortgage is 185k.In the first quarter of 2023, only 38% of house purchase was debt, the rest cash. Pre-Covid, the figure was 47%. We know that for the 1.6 million who will have to renew over the next 12 months, it will be a challenge as they shift from 2% to 6-8%. We also know that 95% mortgages are difficult to obtain.

THE BIG QUESTION IS WILL THE MARKET CRASH?

My judgement is it will not. Average real prices have actually fallen by 12% since the post covid peak. We can expect a further fall of 9%. Prices moved up until May, and now are flat (this is normal in the selling cycle). Journalists are fond of comparing prices to the previous peak, which was last August, and they are currently 3.7% below that.

In nominal terms, on average, I expect prices to reduce by 3% by the end of this year.

Transactions peaked in March and fell to 82,000 in April. I guess year-end we will see a figure of 850,000 for the year, 23% below the norm.

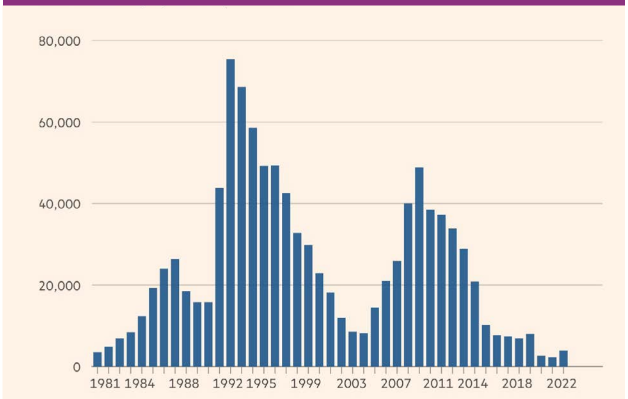
Given that we still expect to run at full employment, that average wages will increase by 5% and that the Bank of Mum and Dad still have considerable funds, I do not expect a repeat of the early nineties, or 2008-12.

In fact, because the UK has a structural housing shortage, for every person unwilling or unable to buy, there will be someone who can, and will, buy.

Will the 1.6 million faced with much higher outgoings on mortgage finance create a recession?

The answer is no. I suspect any supplier to middle market consumers will experience some impact. I guess skiing, long distance holidays and possibly larger SUV demand might soften, but not by much.

Number of UK properties repossessed



More than 80% of UK economic activity and hence employment is in the service sector.

The chart below shows the UK wage price spiral at work. Ideally, this spiral would be broken by the wholesale application of AI to raise service sector productivity, whilst simultaneously reducing the overall demand for people. But this will take a number of years. If the Government is serious about getting inflation down to 2%, we will have to have a recession to reduce the demand for services, and after a year, rising unemployment should break the wage price spiral.

The only way to do it is hit the pockets of those earning over 50K pa by reducing allowances to zero. But the majority of these will be tory voters so it will not happen.

Current policy appears to be as follows:

Tell the B of E to raise rates, blame them for the ensuing property crash, falling asset prices increase precautionary savings, so demand for services decreases, and with a time lag of 18 months, the wage bargaining climate shifts in favour of employers.

In the middle of all this, a general election has to be called.

Number of UK properties repossessed

THE EXCHANGE RATE

As I write this $1.27 is the rate which I forecast at the end of the year. Its noticeable that the forex markets didn't move following the 5% interest rate announcement. They had already priced it in. If the rate moves towards $1.33-35 over the next three months, it strongly suggests that the markets think the Bank will raise base rate beyond 5%. Who knows!

The Euro rate is 1.17 and I doubt if it will go beyond 1.18 this year.

Years of rising house prices have provided an equity cushion

CONCLUSIONS

The UK non-inflationary real growth rate is 1.1% until productivity improves. The Bank of England will keep interest rates around 5%, until inflation falls to 3%. This is unlikely to be achieved for a number of years because labour shortages will ensure wage competition and poaching.

The 'normal' rate of interest is real GDP growth rate, plus 2.5%. So 3.5% is the lowest we will see in the future.

Any growth above 1.1% will require significant labour substituting investment, using AI.

This investment would have taken place since 2016 but for Brexit. It's now an imperative, even though the cost of capital has increased. To repeat, the demographics show labour supply barely growing over the next ten years

The demise of zombie businesses will release some capacity, but continuing labour shortage will keep wage growth around 5%

The housing market will not collapse unless base rate goes above 5%

Lower than expected energy bills in the autumn will give some relief, and support consumer spending before Christmas.

At last the B of E is admitting what some of us have known for years. Their model has a poor record of forecasting inflation because it doesn't include equations which properly reflect the impact of money supply on activity. And the MPC committee members are well respected academics who have little or no understanding how a business works.

If I was in charge, I would ensure 6 out of the 8 MPC members were SME owners. I would have a food producer, (not an importer), a manufacturer, a logistics company, a construction company, an AI creator, and a training/education business. Only two of them would be from London and the SE.

I think the real economy will still manage to avoid recession. We will experience stagflation. A period of very low, or no growth, with persistent domestically-generated price pressures.

The next 18 months is very difficult to forecast accurately. Primarily because human behaviour is volatile and strongly influenced by the media, which has already started to tout the R word.

Rishi Sunak is perhaps hoping that media misery will cause households to reduce their non-essential spend, increase their just-in-case saving, and reduce demand. Thus reducing wage inflation via softer demand for employees.

The only advice I can offer to a business owner is: look at all your processes and ruthlessly search for efficiencies to reduce your demand for scarce and expensive employees. The next 10 years will be labour-shortage years. Businesses which invest heavily in process re-engineering will reap considerable benefits. We all know the biggest obstacle is the human resistance to change, especially when current performance appears to be ok. It there was ever a time for inspiring leadership, it's now.

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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!