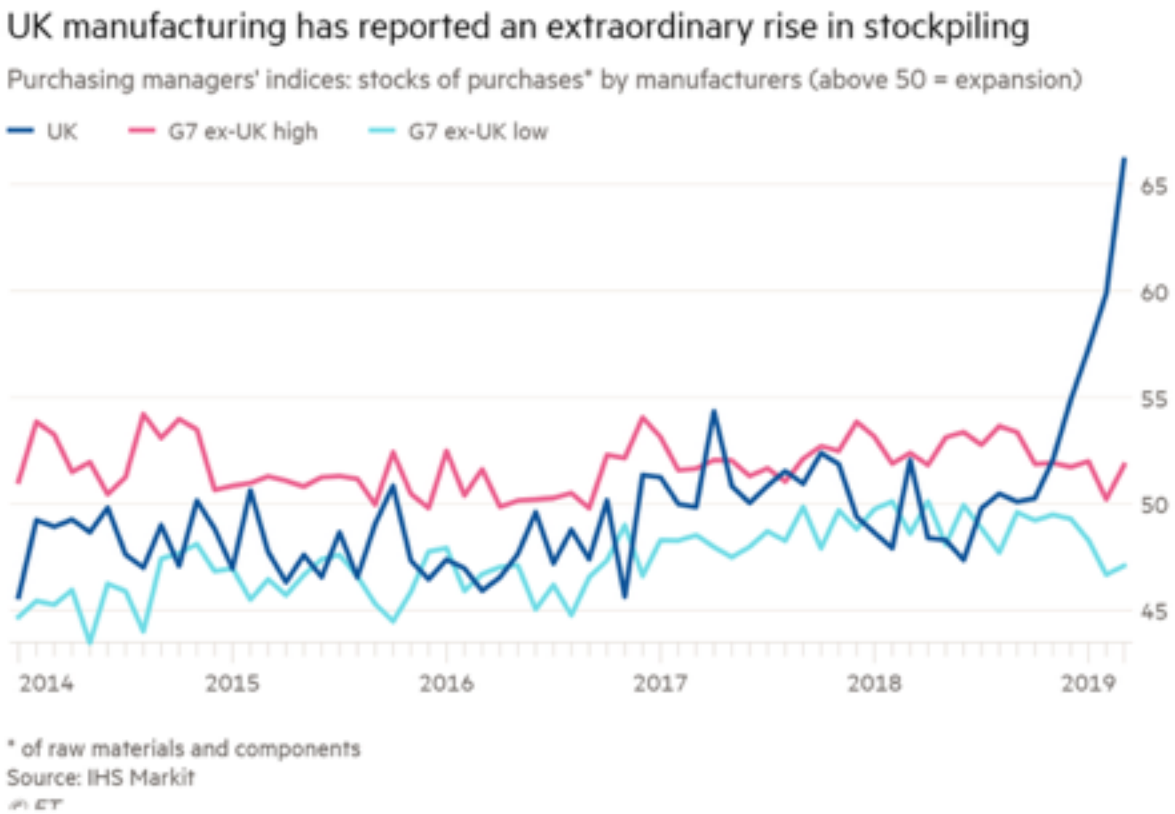
Economic Update May 2019

As I write this there is no clarity from Westminster on how the UK with withdraw from the EU if at all. The uncertainty is weighing heavily on UK investment spending and the velocity of money. UK business is holding onto cash. A recent survey indicated that around £750Bn is currently sitting in cash in UK company balance sheets. This is a record. And it means a third of the UK money supply is not flowing through our economy financing investment in automation, training, equipment and innovation. From the individual company perspective it is prudent, from a system perspective it is damaging.

Additionally the quantity of money in our economy is growing at half the rate required to produce a GDP real growth rate of 2.3%.

In combination it is difficult to be optimistic about the next 18 months. The good news is the Brexit timetable suggests a decision by the end of October. And following a decision one would hope that a good chunk of the £750 Bn would be spent. If so we will avoid recession and may have a growth burst. The so called Brexit dividend .

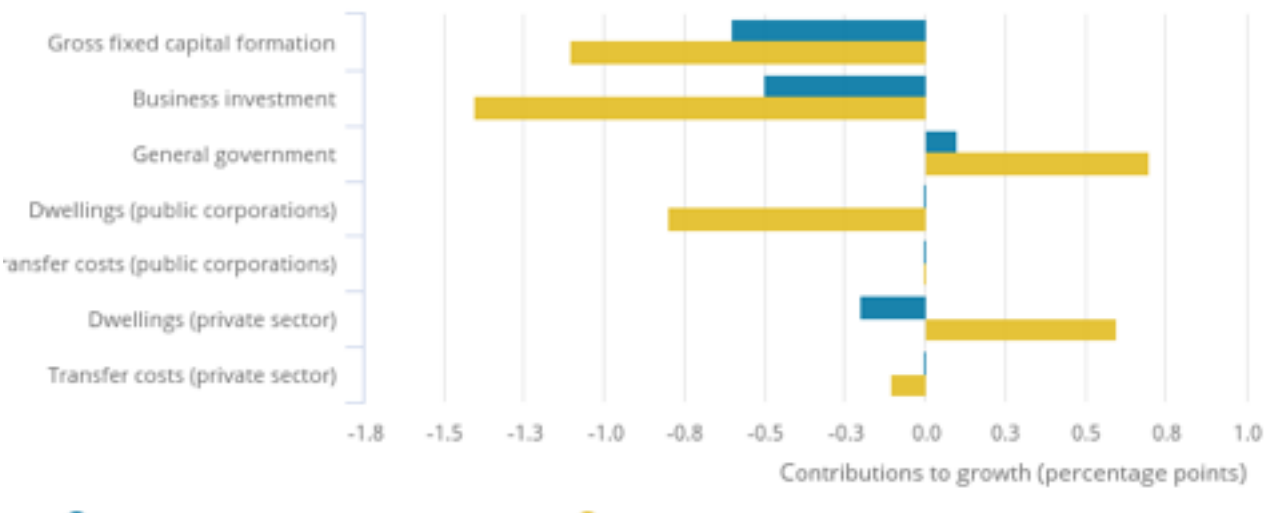


But look at the chart. Stockbuilding boosts intermediate demand but not final demand. The stockbuild is a sensible response by individual companies to possible supply chain disruption. But if the withdrawal deal goes through, then for at least two years and probably three, the UK economically remains part of the EU. Unless final demand increases substantially, destocking will take place and cause a manufacturing recession. A paradox : we have a decision on the EU and we get a mini-

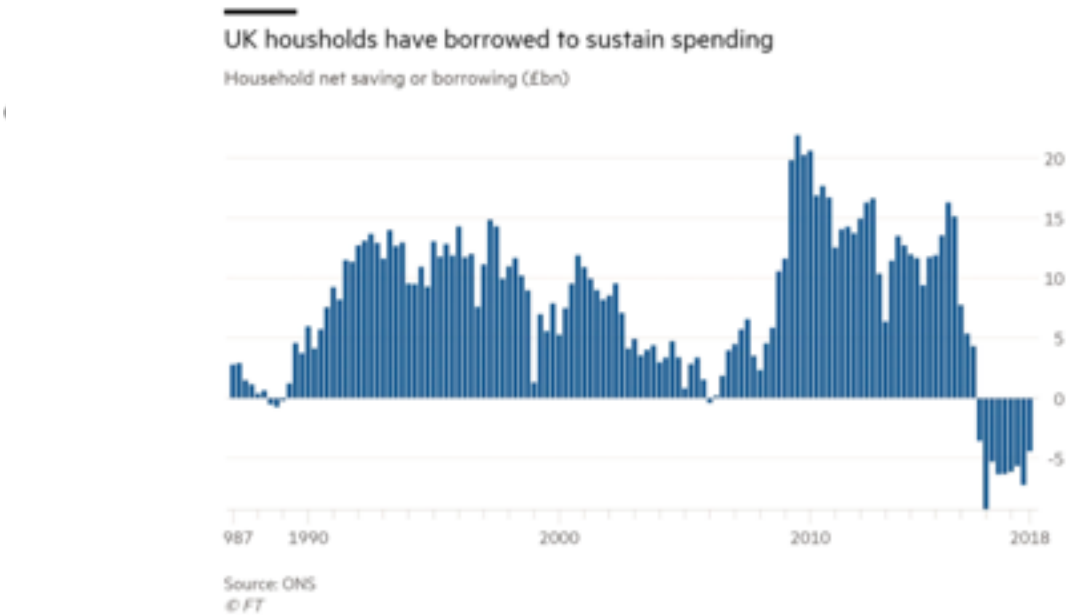
recession! Of course if we leave on WTO terms then the subsequent supply chain disruption will have a reduced impact due to accumulated stock in our system.
The latest data on investment spending is shown below: Brexit uncertainty is clearly having an impact.

Figure 1: In Quarter 4 2018, business investment made the largest negative contribution to growth compared with Quarter 3 2018 and Quarter 4 2017

Chained volume measure, seasonally adjusted, UK, 2016

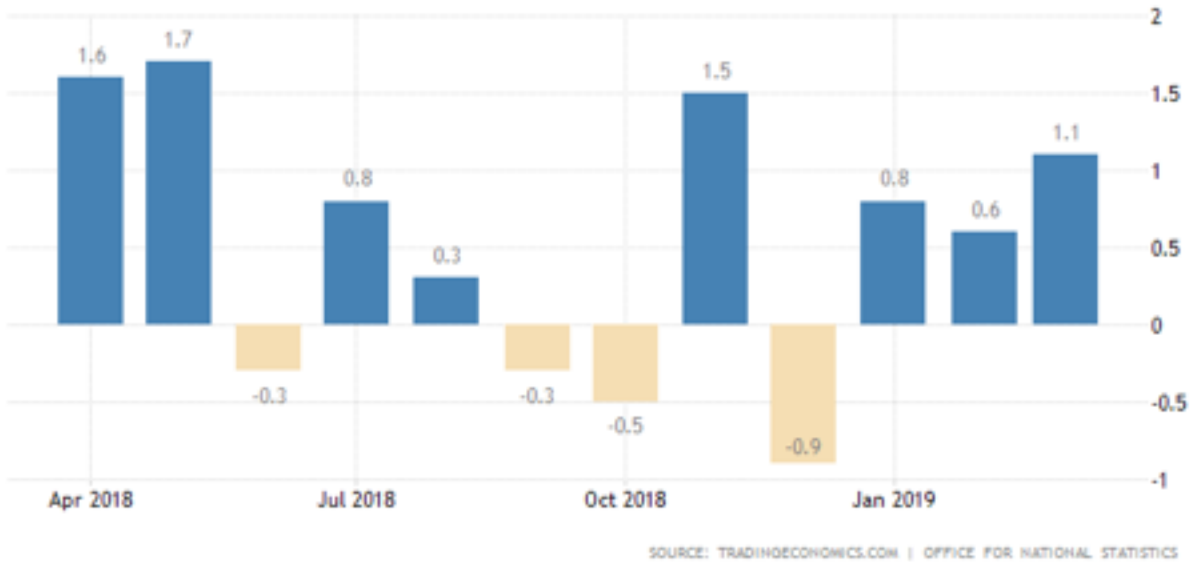


In the last quarter of 2018 the British spent 4.4 Bn more than they earned



Retail sales picked up in April. But the data for the last quarter of 2018 shows that households are still using debt to maintain their lifestyle (and in some cases survive). As the chart shows this has not happened to same degree before. If there is a Brexit dividend then high levels of employment plus real wage growth of 2% will allow indebted households to survive. But if not, then we can expect a significant increase in personal bankruptcies.

UK Retail Sales mom



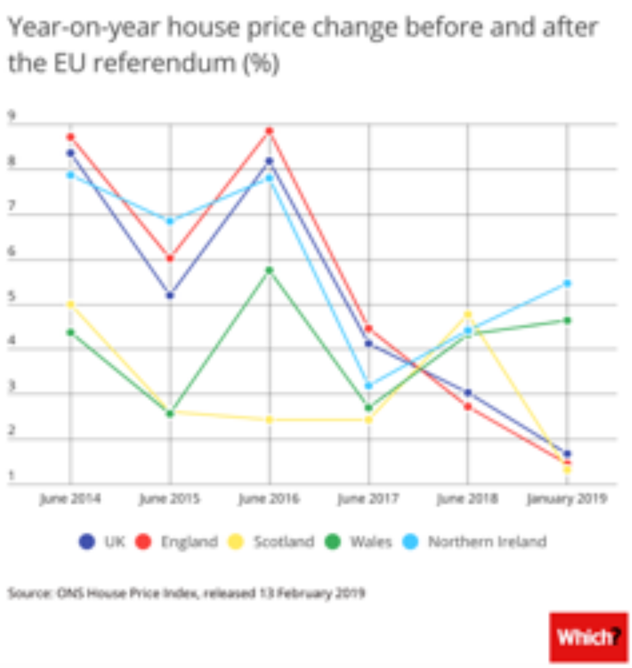
However the big elephant in the room is money supply. As I have said before the UK needs money growth of 4-5% per annum to enable real growth of 2-2.5% with an inflation rate at the target level of 2%.

The chart shows March money supply at 2% growth. Unless this picks up back to 4% we can look forward to a tough 18 months with the UK economy close to recession.

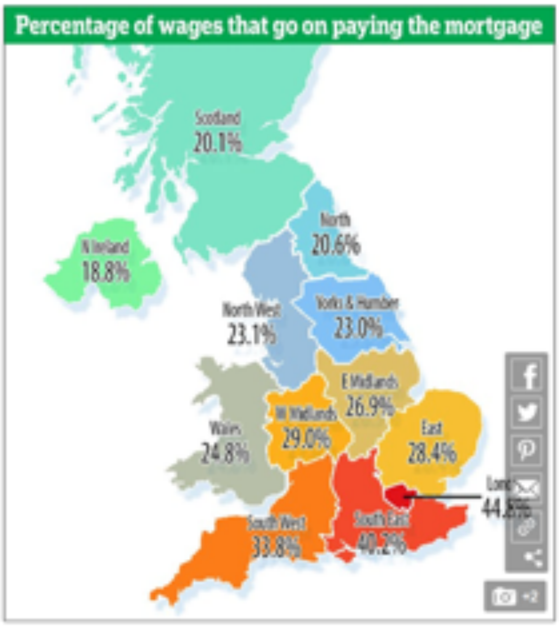
There is some good news. The price of oil is sitting around $62 a barrel. Although UK household utility bills are beginning to reflect last summer’s hike. OPEC have a target price of $70 for the end of 2019 but non OPEC member pump rate might render that unachievable.

The price of oil in US dollars

UK house prices.



It is now well understood that the perceived value of property is the major driver of confidence for bankers and property owning households. There are now significant regional differences. The South has stalled with no price increase in March, but all other regions show growth of between 2 and 5%. I do not think this is a consequence of Brexit. It is because at last the South is showing the long overdue price correction. The sustainable long run average % of after tax income spent on mortgage finance is 33%.



Clearly property in London and the South East is overpriced. And so the price correction should continue until falling prices meet rising incomes. This is not a problem for the average house purchaser who stays in their current house of 7 years. But it may catch out the leveraged speculator (and their bank!)

The Global Economy

Last July I suggested that the global economy was at the top of the cycle. The data since then supports this view. The key question is will we experience more slow down but no recession or a rapid descent into recession.

The effect of the Chinese/ Trump tariff war has reduced trade volumes between them but not by much and the USA is the loser. Exports from the USA to China are down by 30%, but from China to the USA by just 2.8%. And the effect is mitigated domestically by tax cuts in the USA and monetary stimulus in China. China will grow by 6.7% and the USA by 2.3%(the constraint on USA growth is currently labour supply).

Hard data is turning down

Real activity index

Source: FT, Brookings
© FT

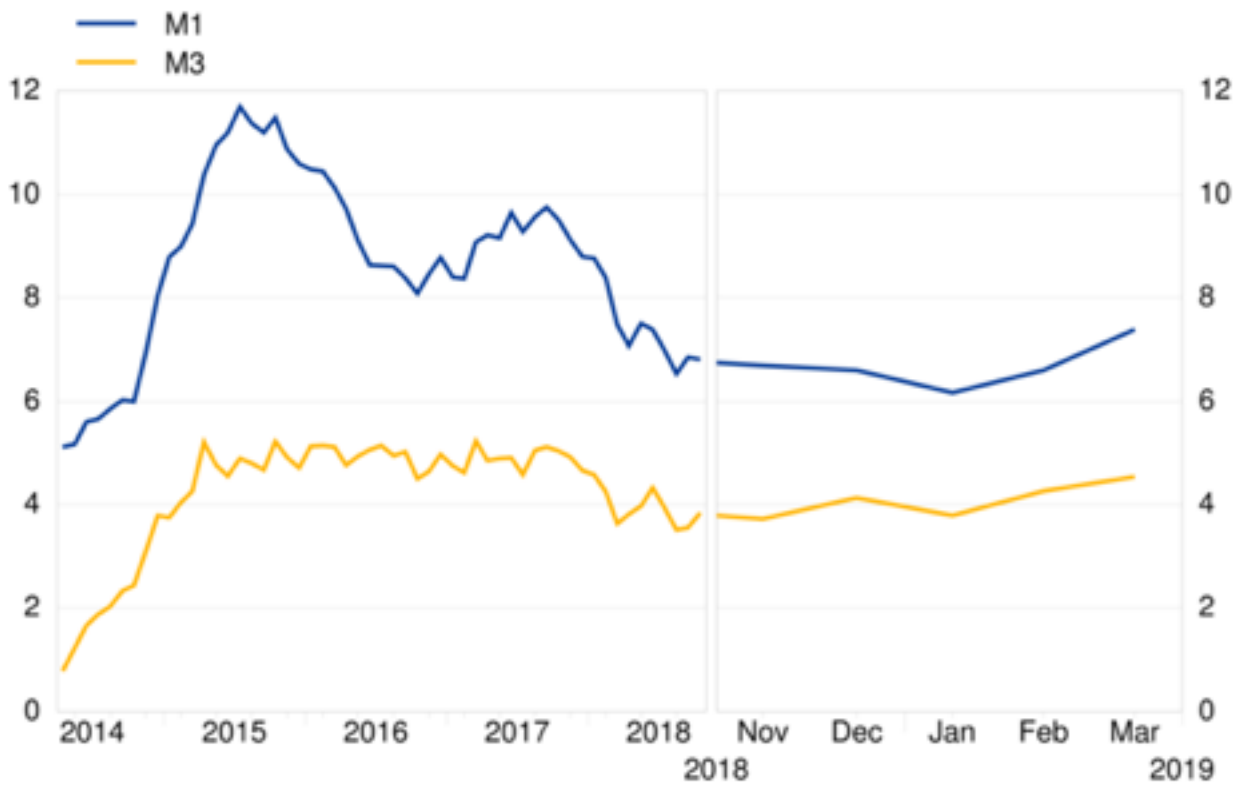
Global trade is shrinking

% change in global trade volumes, year on year

Source: CPB World Trade Monitor
© FT

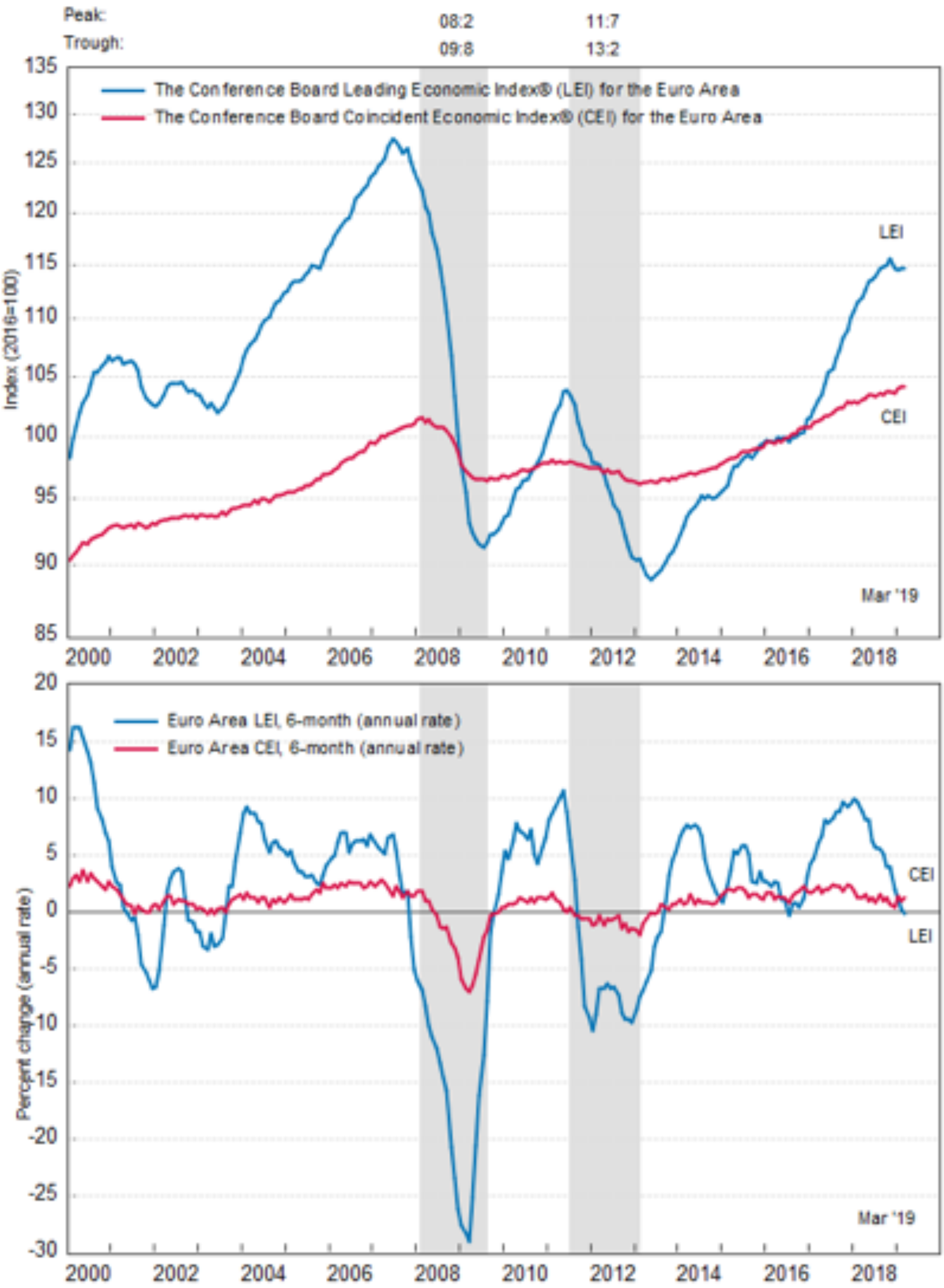
The EU

In recent months Germany has seen a significant slow down in manufacturing due to softer demand for exports. But domestic demand is taking up some of the slack and Germany will grow at 1% this year.



The money supply data suggests the EU as a whole will avoid recession. In the chart M3 is the EU equivalent of the UK M4. You will recall UK money supply needs to grow at 4% but is only growing at 2%. M1 measures the growth in current account balances.
Monetary conditions are just fine in the EU; the question is what will happen to confidence and velocity of money.The retail sales data shown below show a steady performance. Although consumer confidence data indicates a softening.

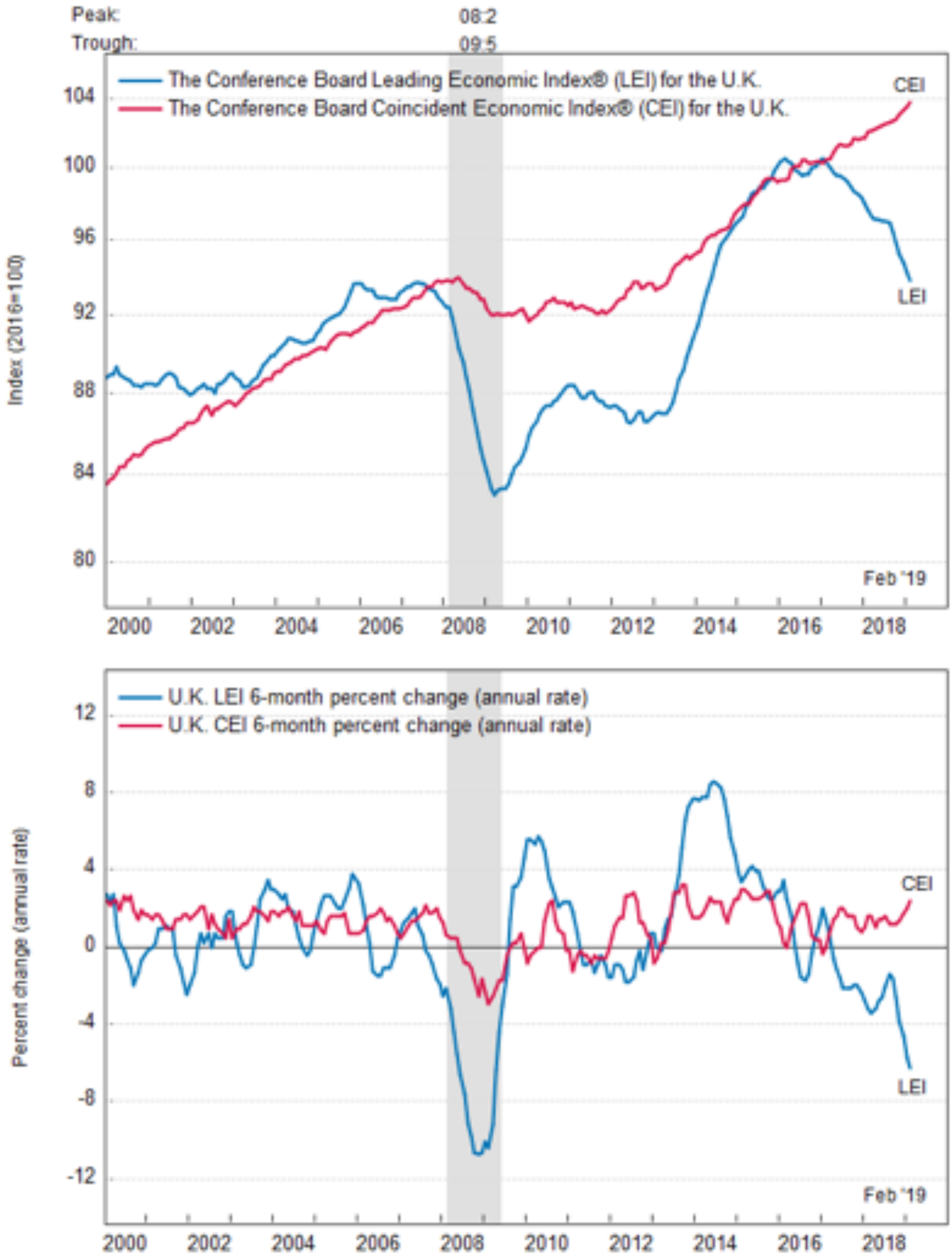
I have to say that if someone gets their view of the EU economy from the Telegraph they would have a much more pessimistic view. But such is the quality and bias of British journalism. In the interests of objective analysis I show below the view of economists in the USA.
The chart is for the EU.



The shaded areas represent business cycle recessions. The peaks and troughs are designated by The Conference Board based on the coincident index and real GDP.
Source: The Conference Board

The Longer Leading Indicator is a composite index composed of 7 time series it looks ahead for about a year. The Coincident Indicator is the cycle itself. The chart suggests that over the next year the EU will grow but at a lower rate.

Now we look at the same indicators for the UK. Note the chart says Feb19 but the data is for March19. They suggest the UK will be close to or in recession a year from now. This is consistent with the money supply data (which is not one of the 7 time time series)



The shaded areas represent business cycle recessions. The peaks and troughs are designated by The Conference Board based on the coincident index and real GDP.
Source: The Conference Board

Now for the school report.

Here are the forecasts I made two years ago.

Averages of 27 other forecasters' central projections May 2017

RMF view in red

	2018 Q2	RMF	2019 Q2	RMF	2020 Q2	RMF
CPI inflation[b] yoy	2.8	3.2	2.4	3.0	2.2	3
GDP growth[c] yoy	1.3	1.7	1.7	1.9	1.9	2.1
LFS unemployment rate	5.1	4.8	5.3	4.8	5.3	4.8
Bank Rate (per cent)	0.4	0.5	0.5	1.25	0.9	1.5
Stock of purchased gilts (£ billions)[d]	438		439		439	
Stock of purchased corporate bonds (£ billions)[d]	10		11		11	
Sterling ERI (exchange rate index)	77.6	77	77.4	77.8	77.6	77
Growth in average earnings (basic plus overtime)		2.5		3.6		4.0

RMF forecast assumes a transitionary deal which maintains access to the single market from early 2020 will be signposted mid 2018

RMF assumes number of EU workers will fall by 700,000 to 1.9 million increasing the pressure on wages

CPI inflation for Q2 is expected to be 2%, my forecast of 3 clearly incorrect.
GDP growth for Q2 is expected to be 1.3% my forecast of 1.9 again wrong
Unemployment rate is 3.6%, I forecast 4.8%
Bank rate 0.75% I forecast 1.25%
Exchange rate index 77.5 I forecast 77.8
Growth in average earnings 3.4 I forecast 3.6%

I assumed a deal would be done by now Ha!

Number of eu workers has only fallen by 268,000

What follows is a direct quote from my school report aged 13.

Martin-Fagg is not bottom of the class this year because of a new boy who arrived recently

So it would seem nothing has changed!

Here are my forecasts for the next two years

	2019	2020
Real GDP	1.1%	0.3%
CPI inflation	2%	2%
Unemployment	3.8%	4.4%
Bank Rate	0.75%	0.75%
Earnings	3.6%	3%
Exchange rate index	77	76
Average house prices	2%	1%

On Brexit I have no idea!

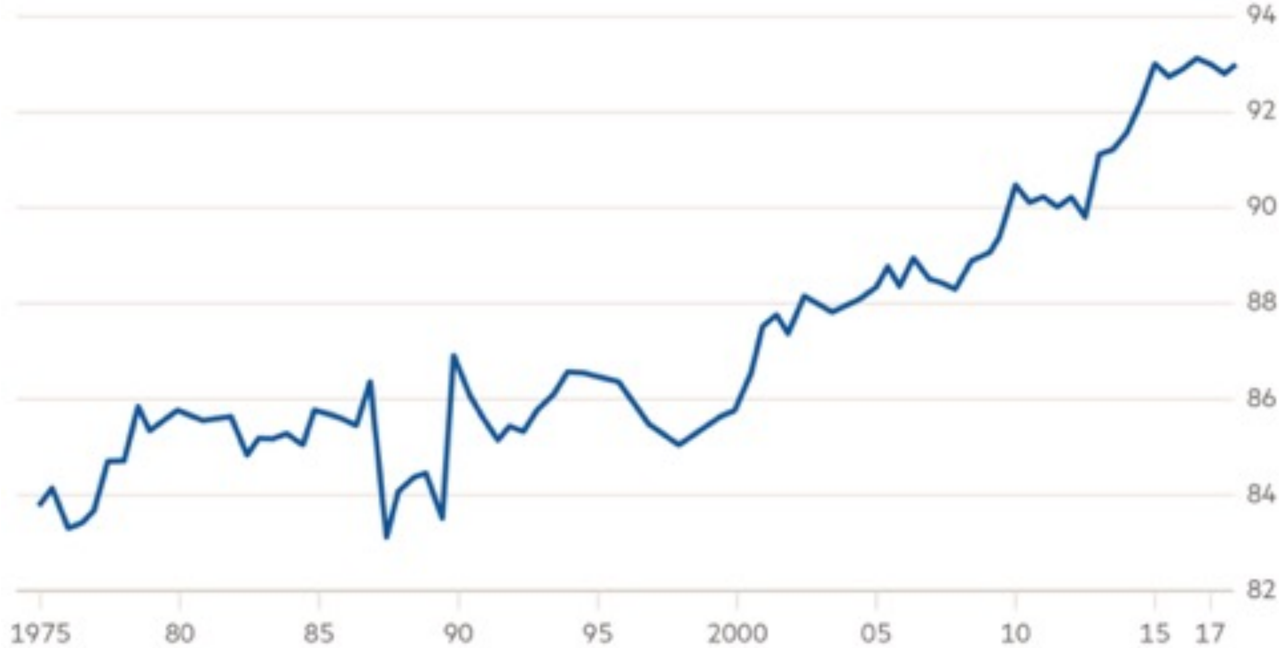
As individuals we cannot control national or international events. We should only worry about that which we can control which is our attitude to others. At a time of political turmoil we should always respect the opinion of others even if we fundamentally disagree. Over the next two years the potential for significant societal unrest will exist. We should ensure a balanced, and measured response to others. And avoid posting tweets, emails and other social media which have not been carefully thought through as to how the wording might be interpreted.

Despite everything a recent survey shows that 93% of the British are fairly or very satisfied with their life on the whole (see next page). Long may it continue.

Prepared May 9 2019
Rmfagg@aol.com

Proportion in the UK who say they are 'fairly satisfied' or 'very satisfied' with their life on the whole

Per cent



Sources: Resolution Foundation; Eurobarometer