# Economic Update

JUNE 2020

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An economy is a set of linked markets

The linkage is the flow of income and expenditure

Incomes are generated when a person adds value to land,intellect,creativity,and physical effort

Emotion and the media cause expenditure flows to deviate from income flows

Governments have no money of their own

46% of the UK population pay no income tax

The NHS is not free. It costs on average each income tax payer £5,200 per annum

Recessions are caused by an unexpected drop in expenditure

The UK created a flow of £2.3 trillion in 2020

The sixth largest in the World

Third largest banking sector
£800Bn is traded every day on the London forex market
Tenth in exports

Only eighteenth for innovation

And nineteenth for health

SMEs represent over 90 per cent of the business population,
60-70% of employment and 55% of GDP in developed economies.

SMEs ARE THE GLOBAL ECONOMY

# MEASURING THE FLOW

-12% March
-35% April
-18% May

SALES REVENUE

Data obtained from VAT expenditure survey and card transactions

subtract

ALL PAID INVOICES

=

Data obtained from PAYE and tax returns

PROFIT AFTER TAX AND INTEREST

+

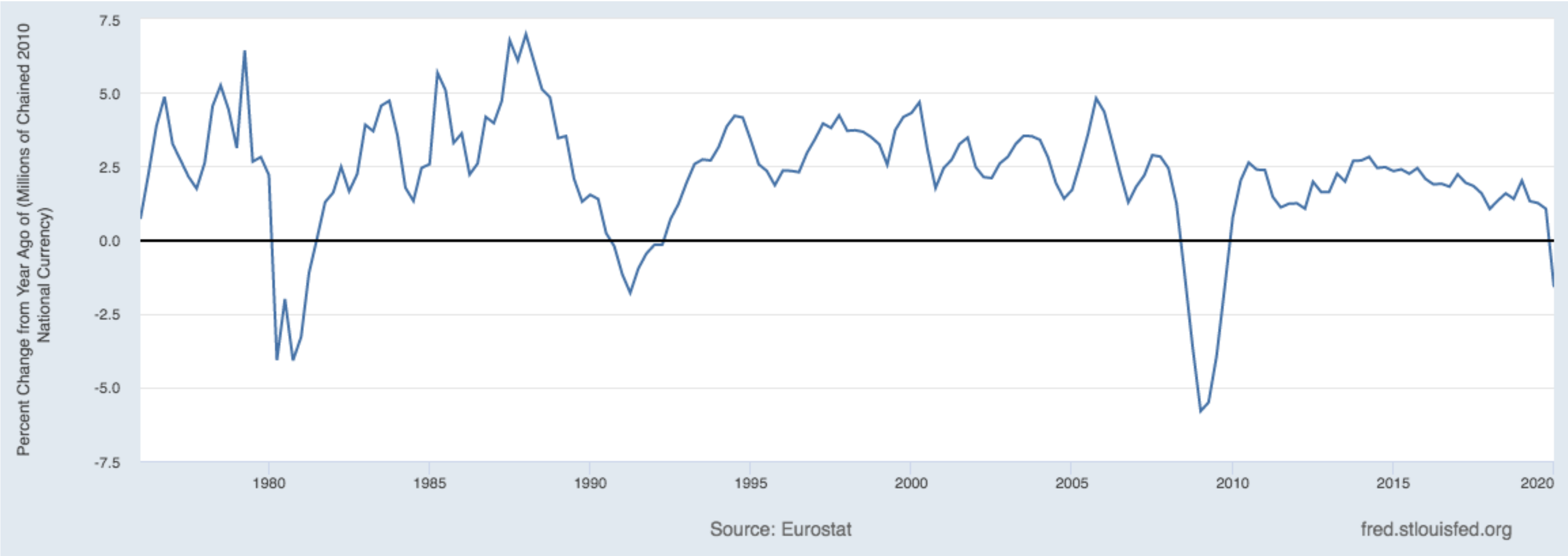
WAGES AND SALARIES

-3% March
-15% April

The UK generates around £200 Bn per month

# UK Real growth yoy

Average  2.3% since 1970




1979-81 recession caused by oil price, inflation and interest rate increases

1990-92 Ditto

2008-10 Oil price and banking collapse

# SHORT RUN ECONOMIC ACTIVITY

is driven by the flow of spending

MONEY X VELOCITY = NOMINAL GDP

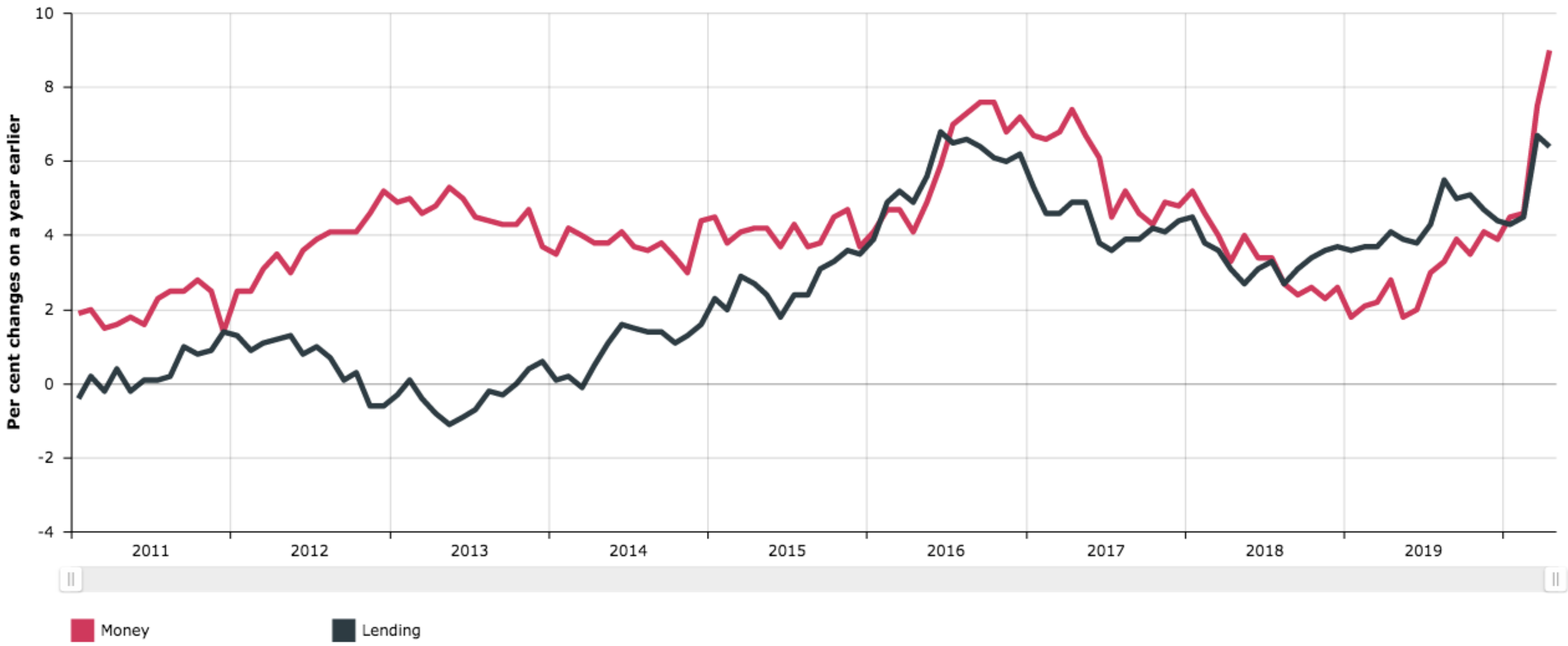
95% manufactured by commercial banks

Determined by interest rates, the media, the weather, house prices but above all CONFIDENCE


Banks manufacture money when they make a loan(bank credit)and can destroy money when a loan is paid down.

## Today’s money supply drives nominal GDP within two years

UK house prices respond within 9 months



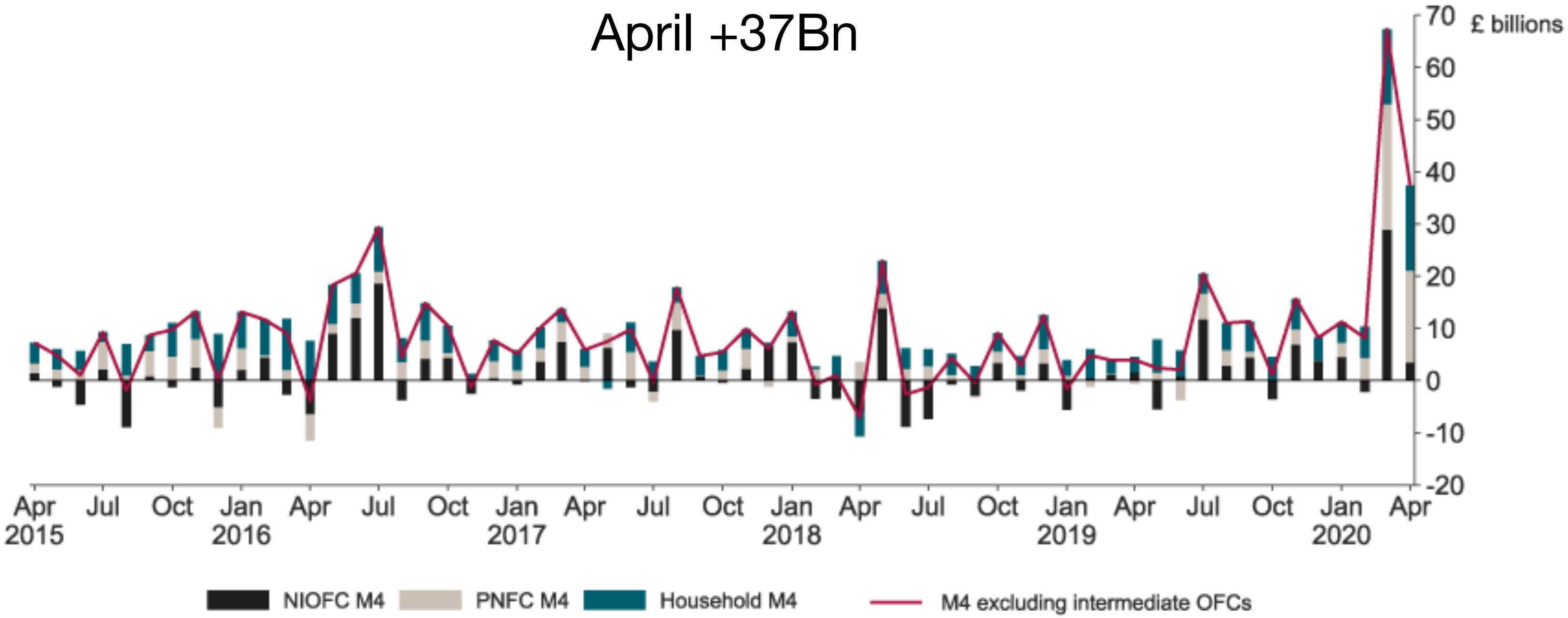

For steady state growth in GDP we need 4% growth in money

There is **loads** of money in our system

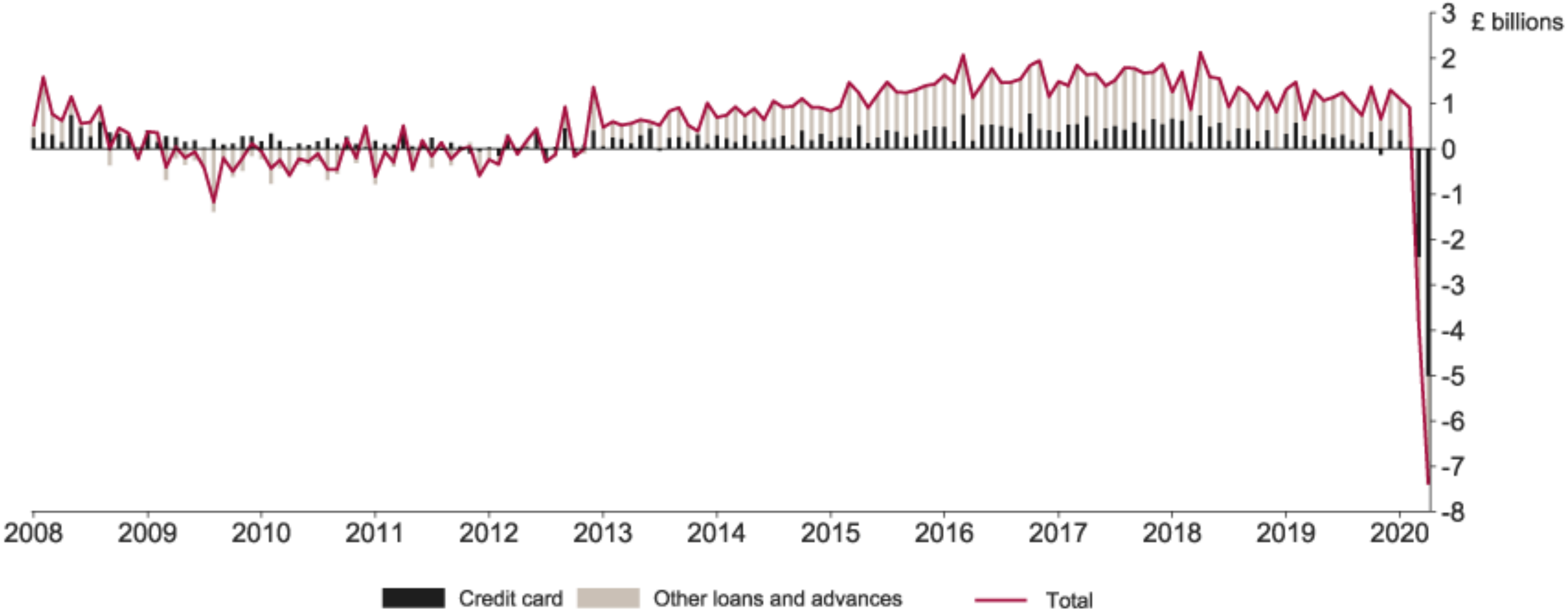
Normally up 10Bn a month

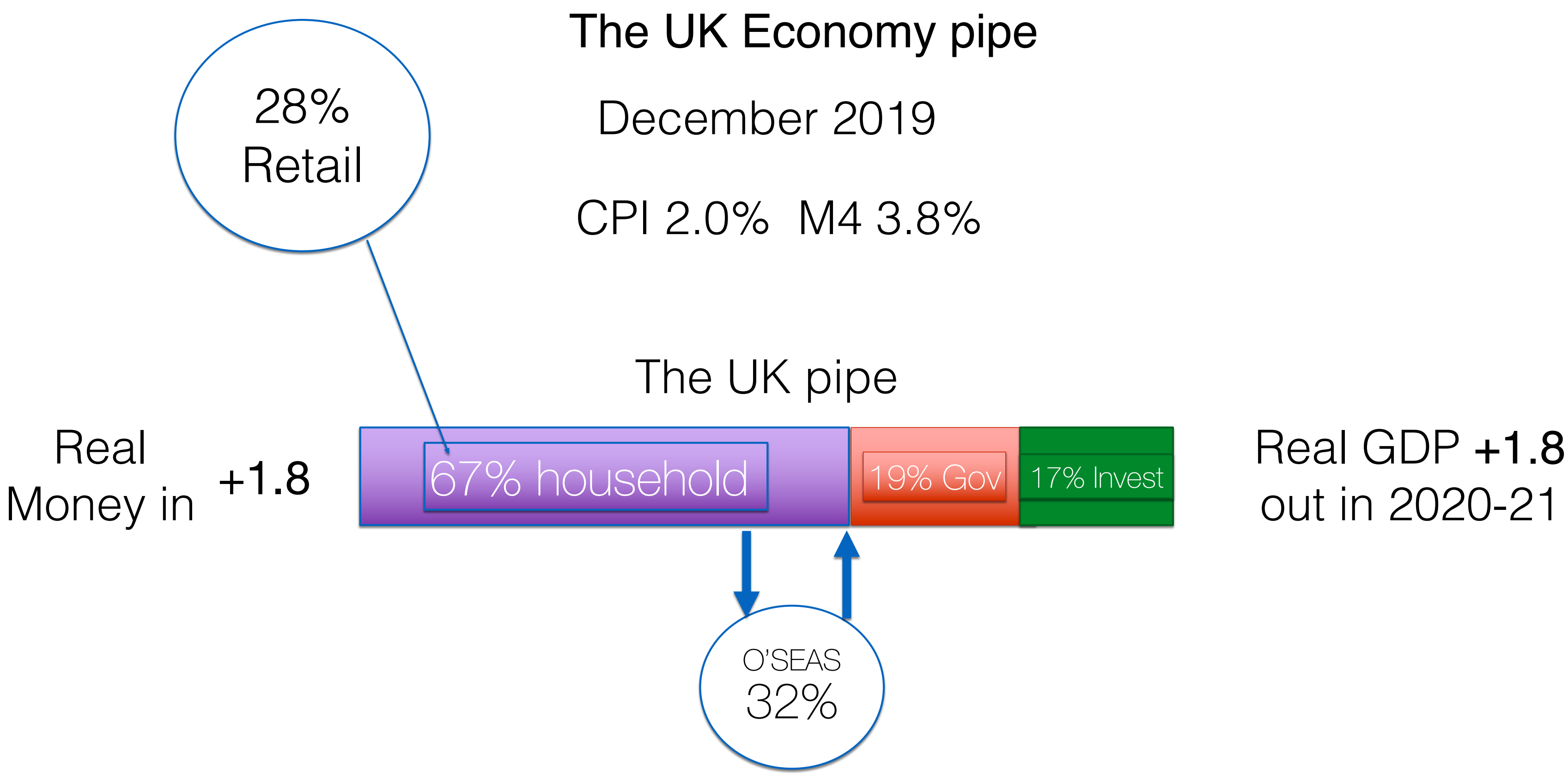
March +67Bn

April +37Bn



# Cash rich households are paying down debt



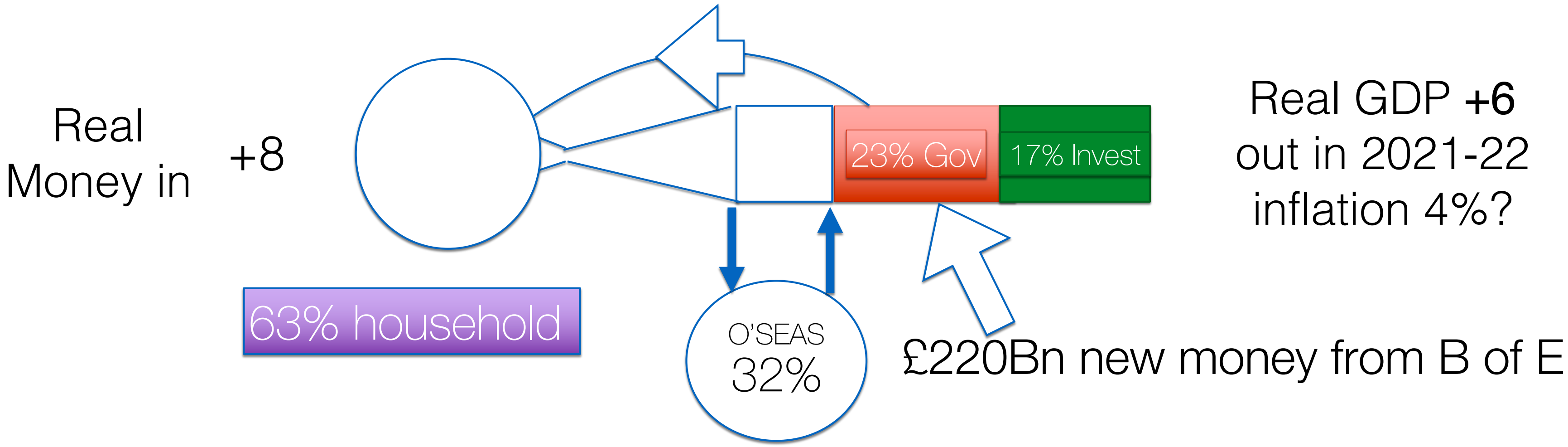

The UK Economy pipe
December 2019
CPI 2.0%  M4 3.8%
28%
Retail
The UK pipe
Real
Money in
+1.8
67% household
19% Gov
17% Invest
Real GDP +1.8
out in 2020-21
O'SEAS
32%

## The UK Economy pipe

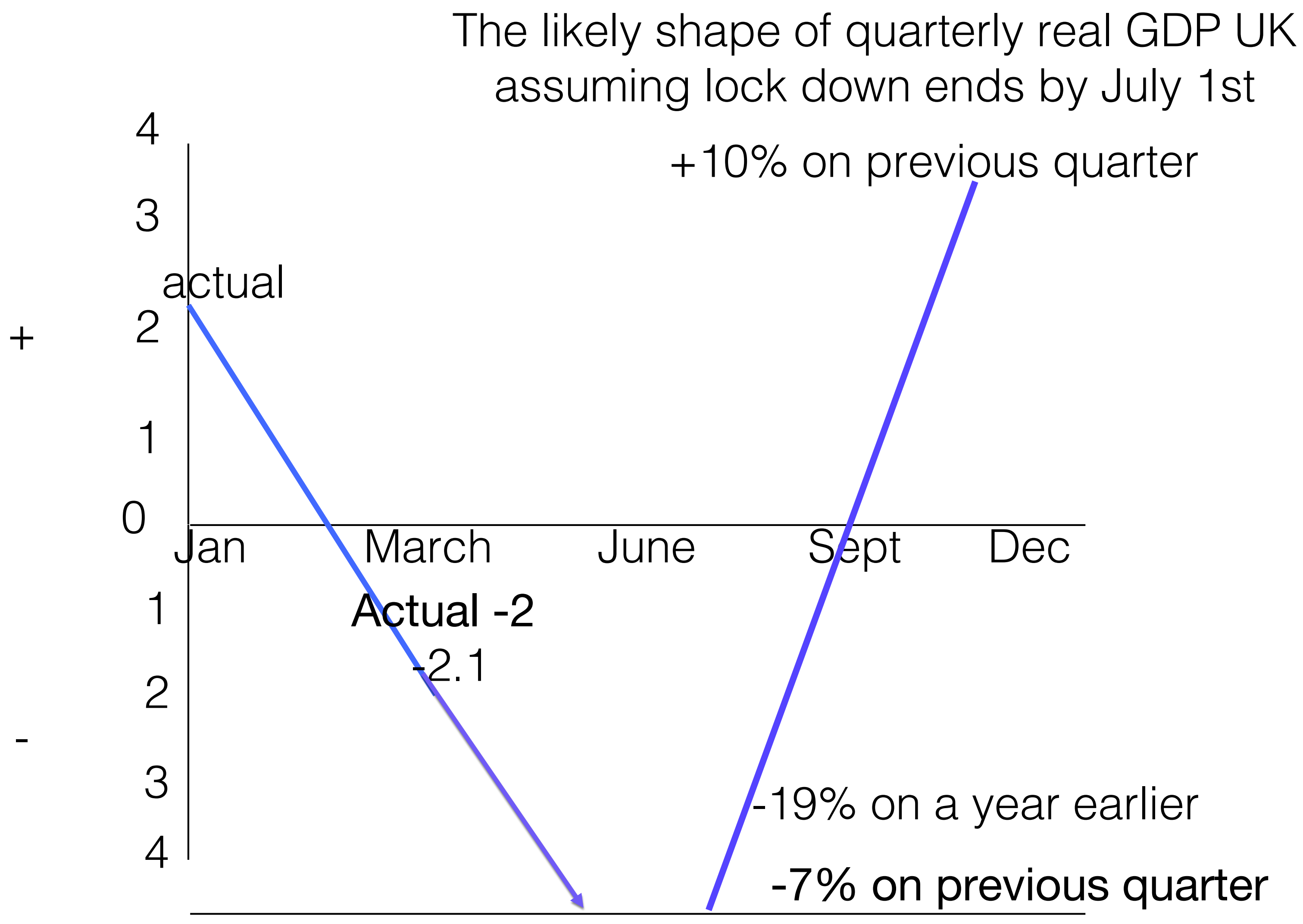
April-August 2020

CPI 2.0% M4 +10%

The UK pipe with lock down kink plus Govt. spend

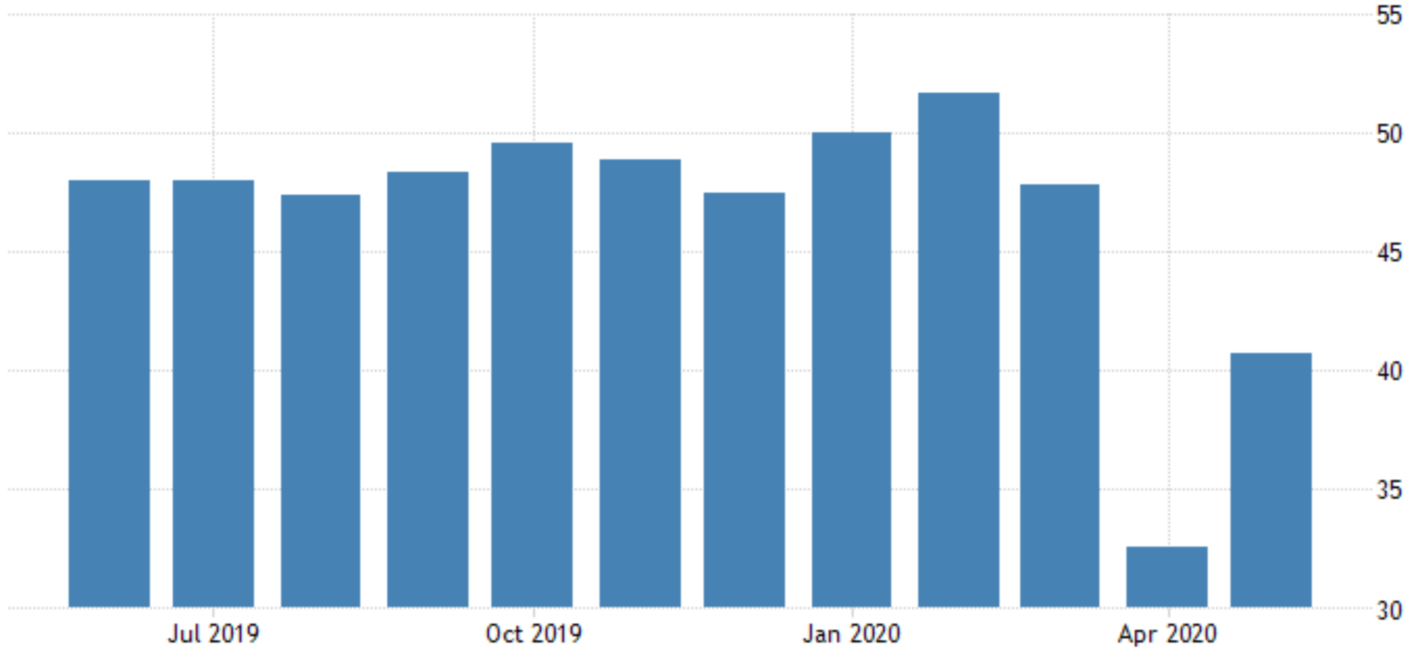



The key is how soon the removal of the kink allows the new money to flow through the pipe

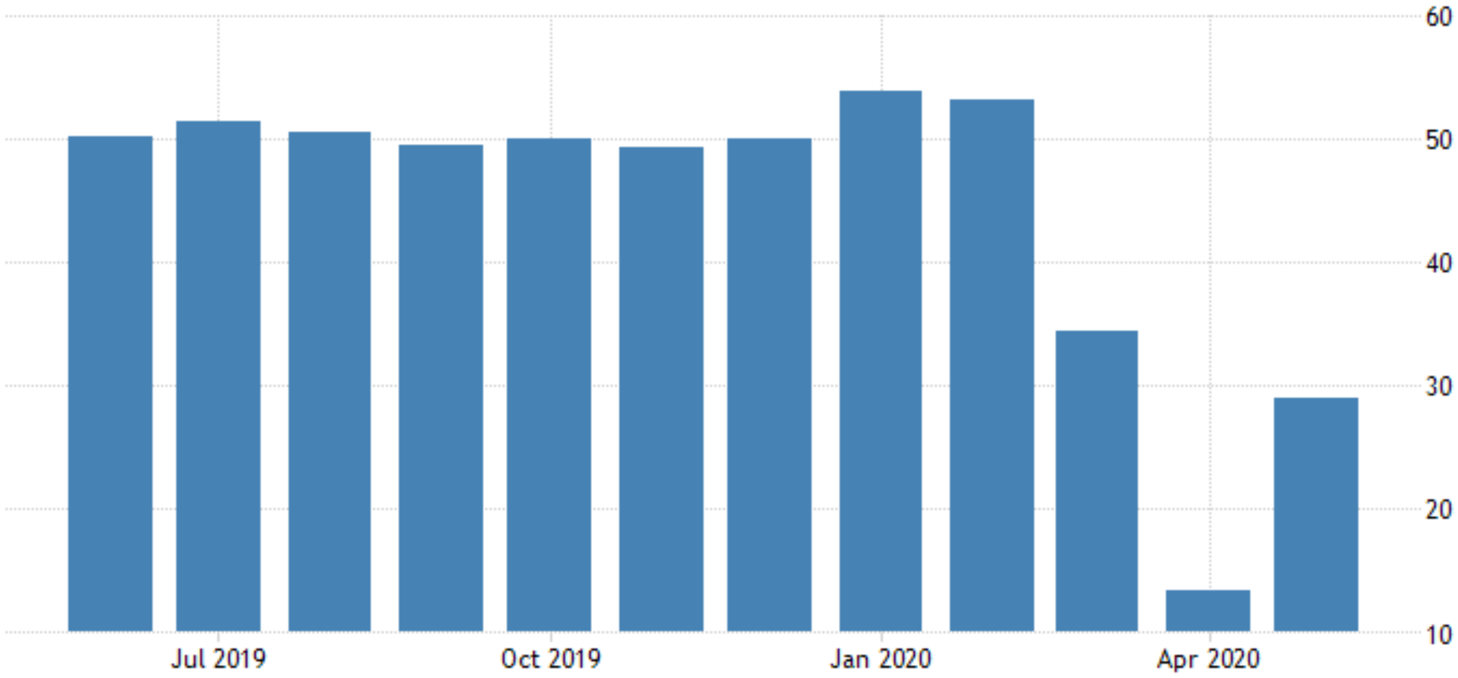


The likely shape of quarterly real GDP UK
assuming lock down ends by July 1st
+10% on previous quarter
4
3
actual
+
2
1
0
Jan
March
June
Sept
Dec
1
Actual -2
-2.1
2
-
3
-19% on a year earlier
4
-7% on previous quarter

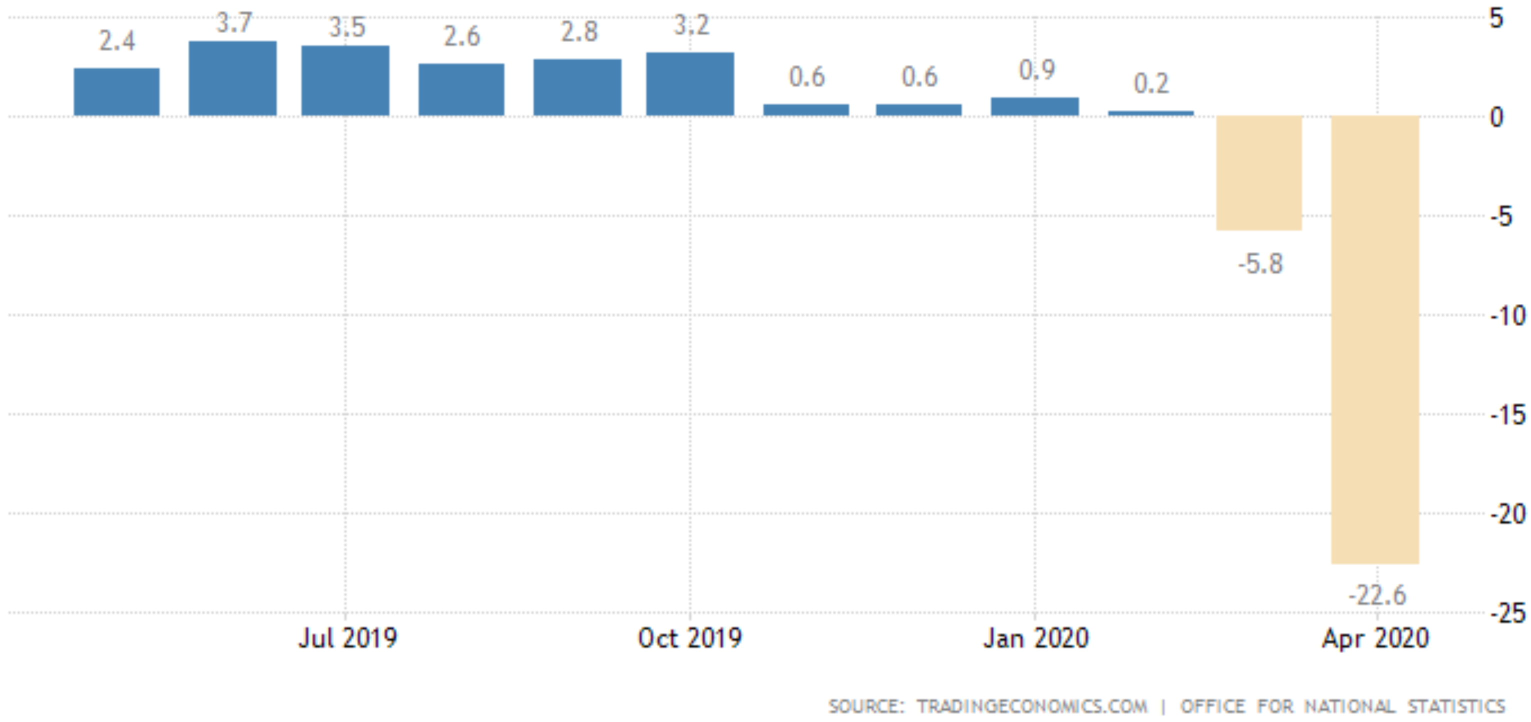
# UK Manufacturing PMI May 2020



## UK Services PMI

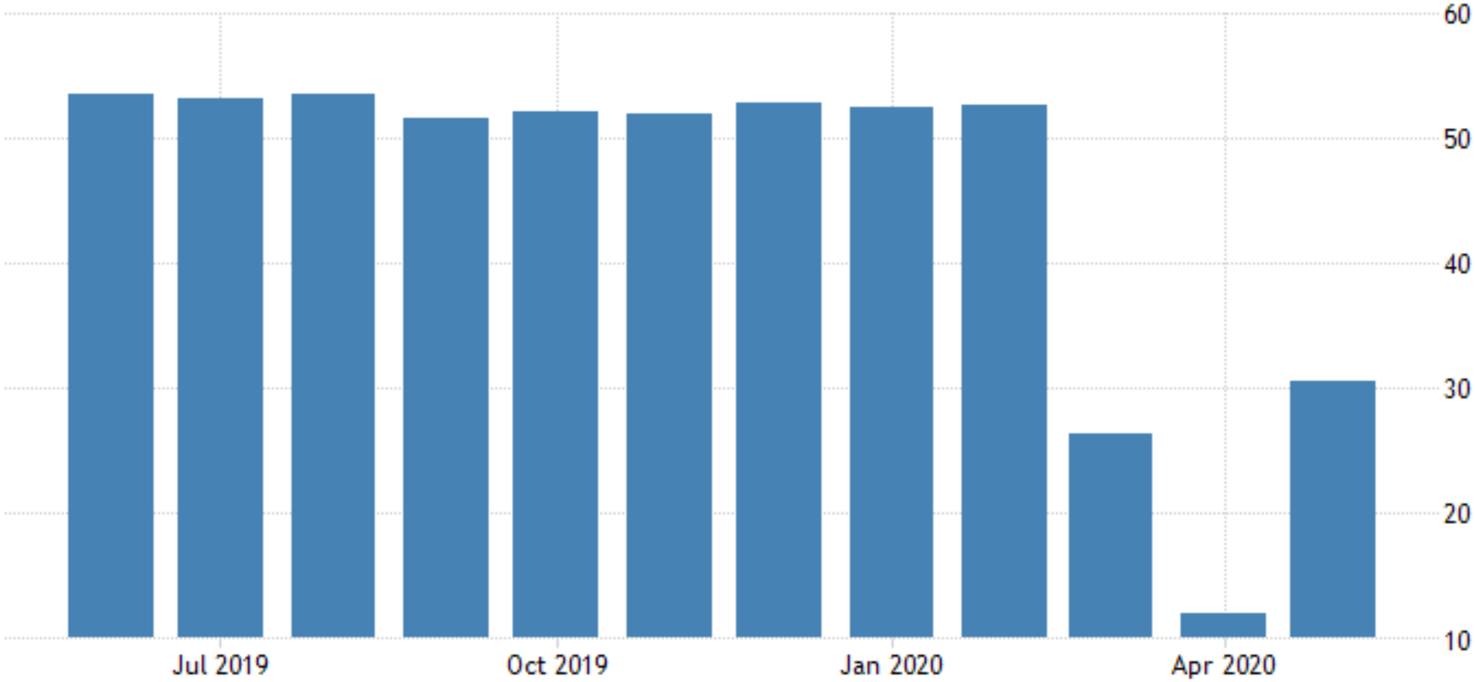


# UK Retail Sales yoy

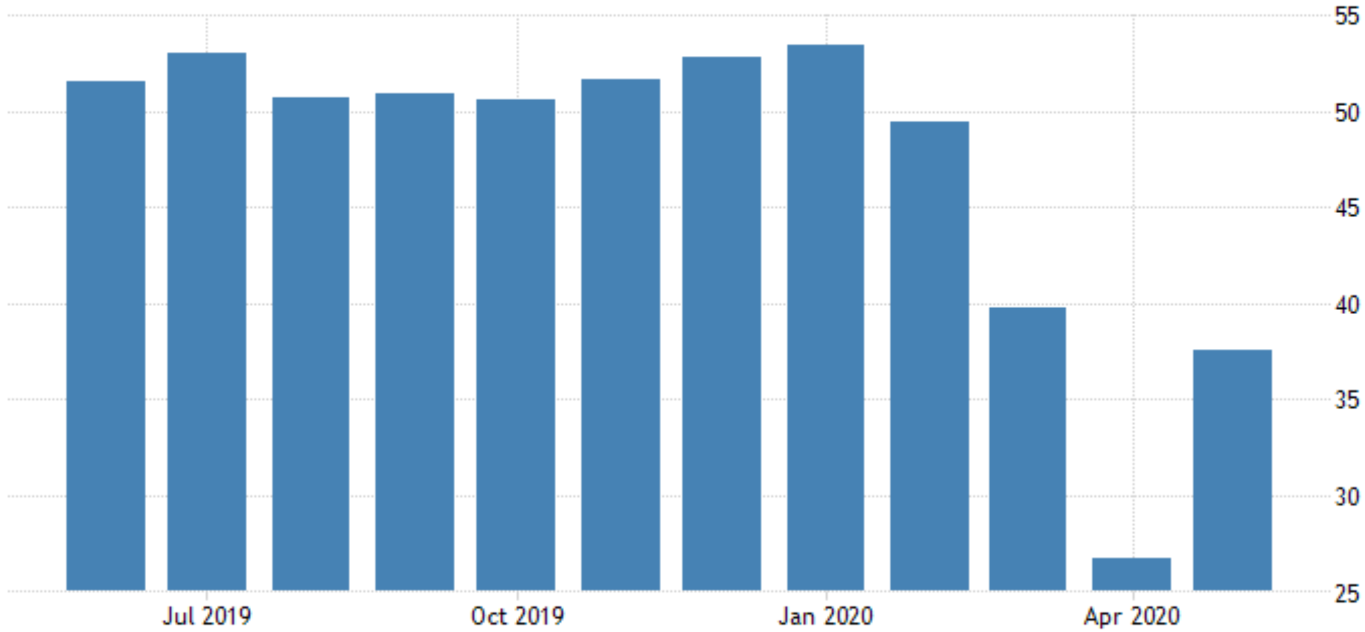


# Germany Retail Sales yoy

The Eurozone Services PMI



USA Services PMI

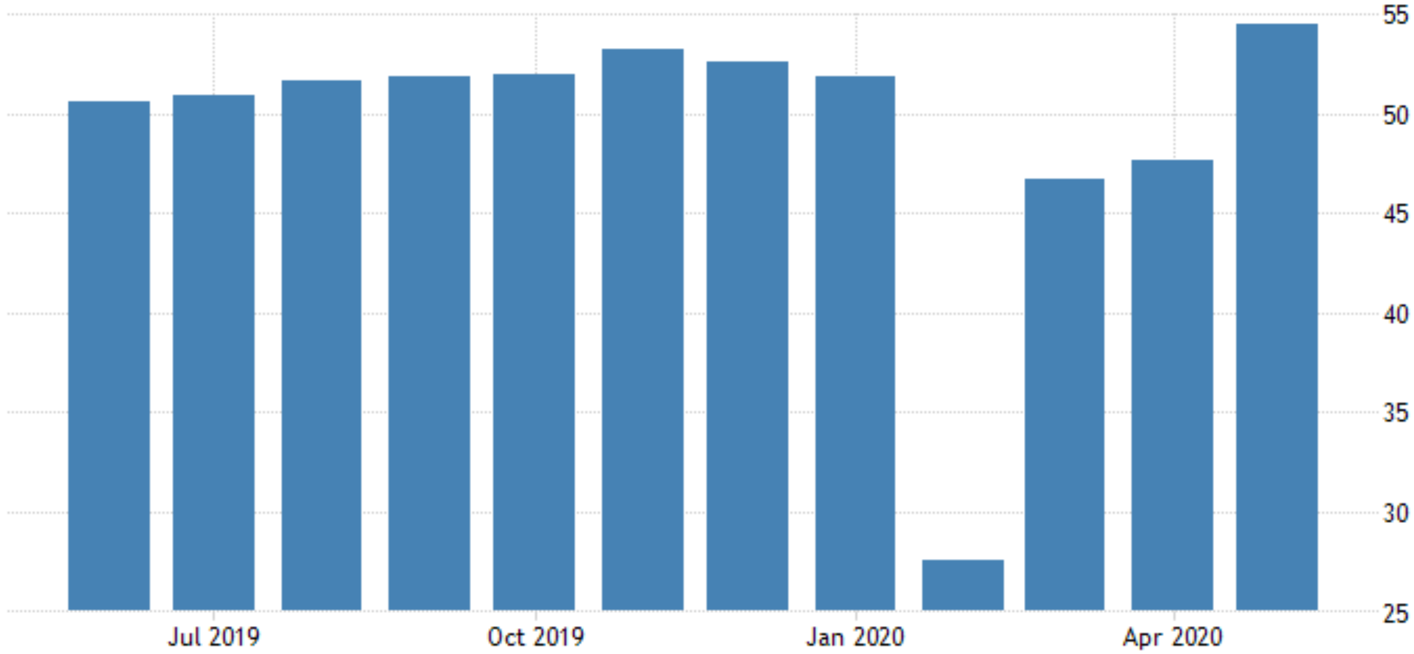



Economists forecast 7.5m jobs lost for May

ACTUAL : 2.5m new jobs created!

China all sectors PMI

*Back to normal!*



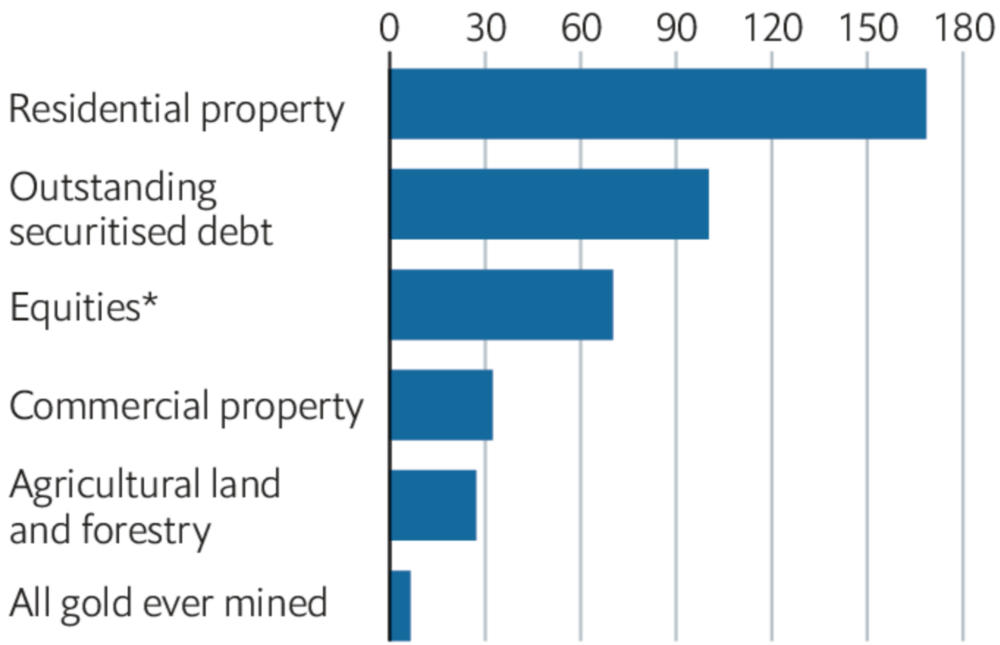
Equity values have dropped between 30 and 40%

BUT

**Home is where your wallet is** **and if house prices are stable no prolonged recession**

Global values of asset classes, $trn

2017




Source: Savills *FTSE Global all cap index

## How we behave

House prices much more important than equity prices

Most people wish to maintain monetary equilibrium and adjust their spending accordingly

**Excess money is spent creating sales and income growth**

**Insufficient money the reverse!**

A recession is two successive quarters of negative growth

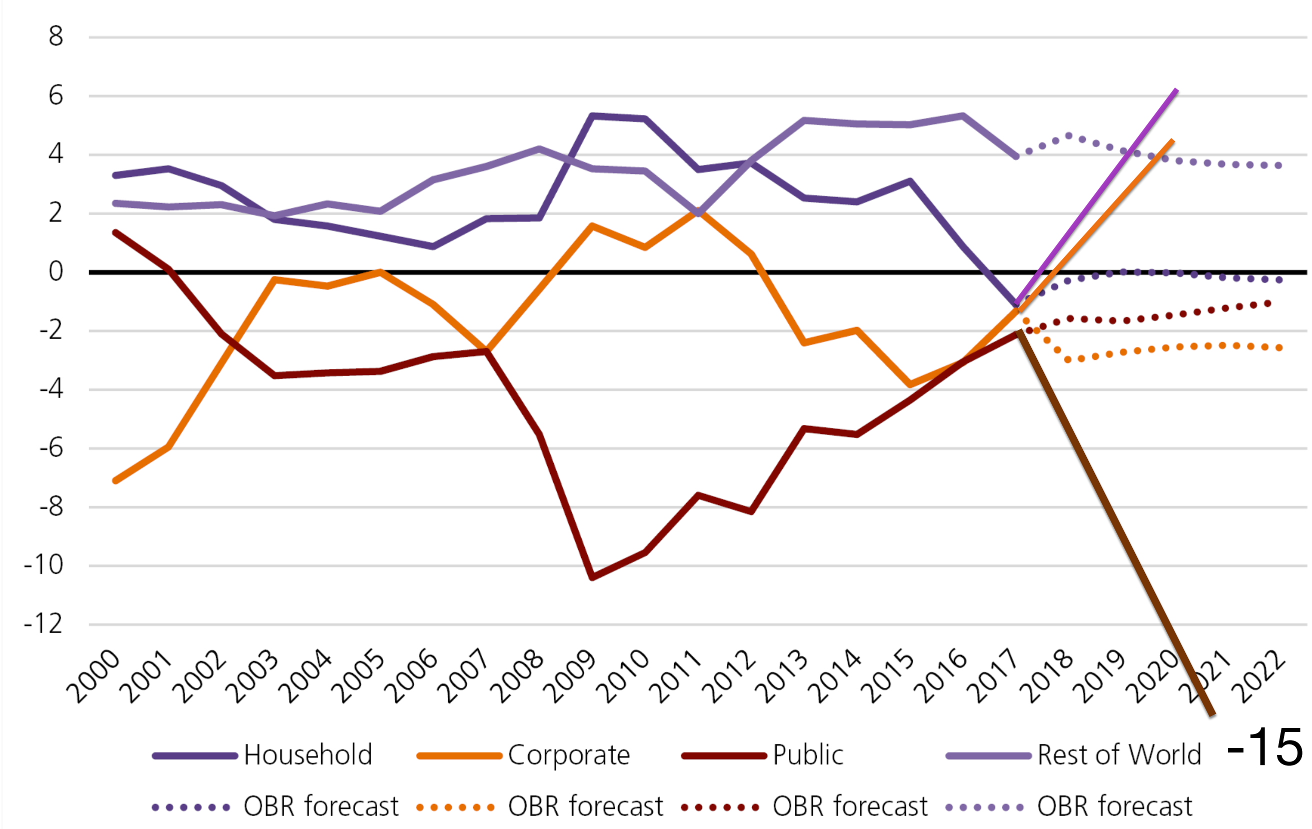
Since 1950 recessions have been primarily caused by an increase in the price of oil, inflation and rising interest rates causing insufficient end of month money

The 2008 recession was caused by a collapse in the banking system

**The 2020 recession caused by inability to spend!**

Pre Covid sectoral balances …………..

Excess money in business and family accounts will be spent!



## Explaining the Chart

The sum of debits must equal sum of credits

A Government deficit is a debit for it but a credit for households and businesses

The balance of payments deficit of 4% has to be financed by inflows from abroad. These are shown as a credit.

In simple terms if the Government borrows £300bn from the Bank of England over the next 18 months then it ends up in the bank accounts of families and companies

NB by August the Government will have borrowed circa £180Bn

## The outlook for house prices

Since 1973 significant increases in the money supply have always driven up selling prices

In 2021 I expect average prices to rise 5%

More flexible home working likely to soften prices in prime commuting areas and raise prices in cheaper more rural locations

*The provisional seasonally adjusted estimate of UK property transactions in March 2020 is 99,440 residential and 9,470 non-residential.*

The volume of transactions is likely  to pick by October and return to pre-covid levels circa 105,000 per month

The expected rise in unemployment will be temporary

Mortgage finance has never been cheaper

Inflation adjusted mortgages are free money!

## The £200Bn deficit and its impact on interest rates

The long run rate of interest depends on the market price of debt

If supply exceeds demand the price falls and the rate of interest rises

The Bank of England will ensure sufficient demand
by buying the whole monthly issue if necessary

Currently the long run rate is 1% and is unlikely to change for next two years

**UK gilt issues**
ICAEW chart of the week

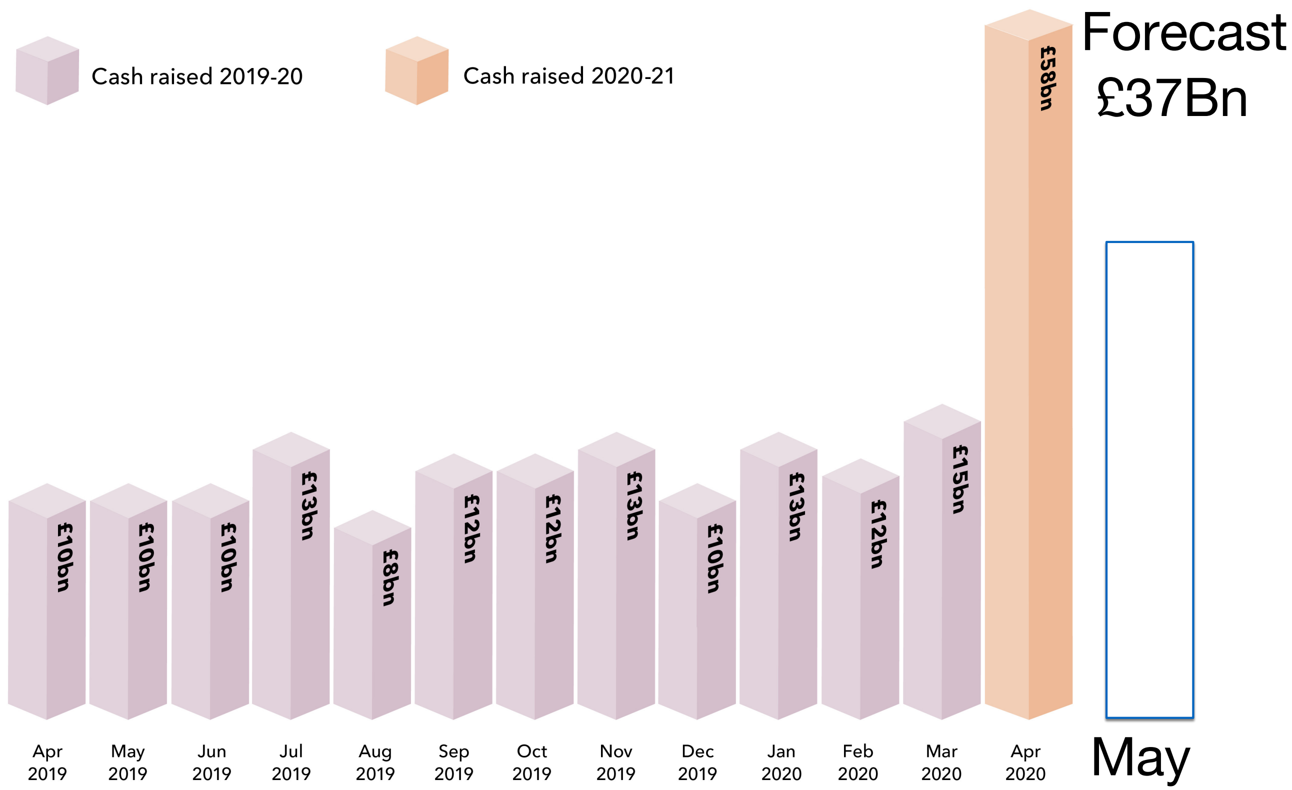
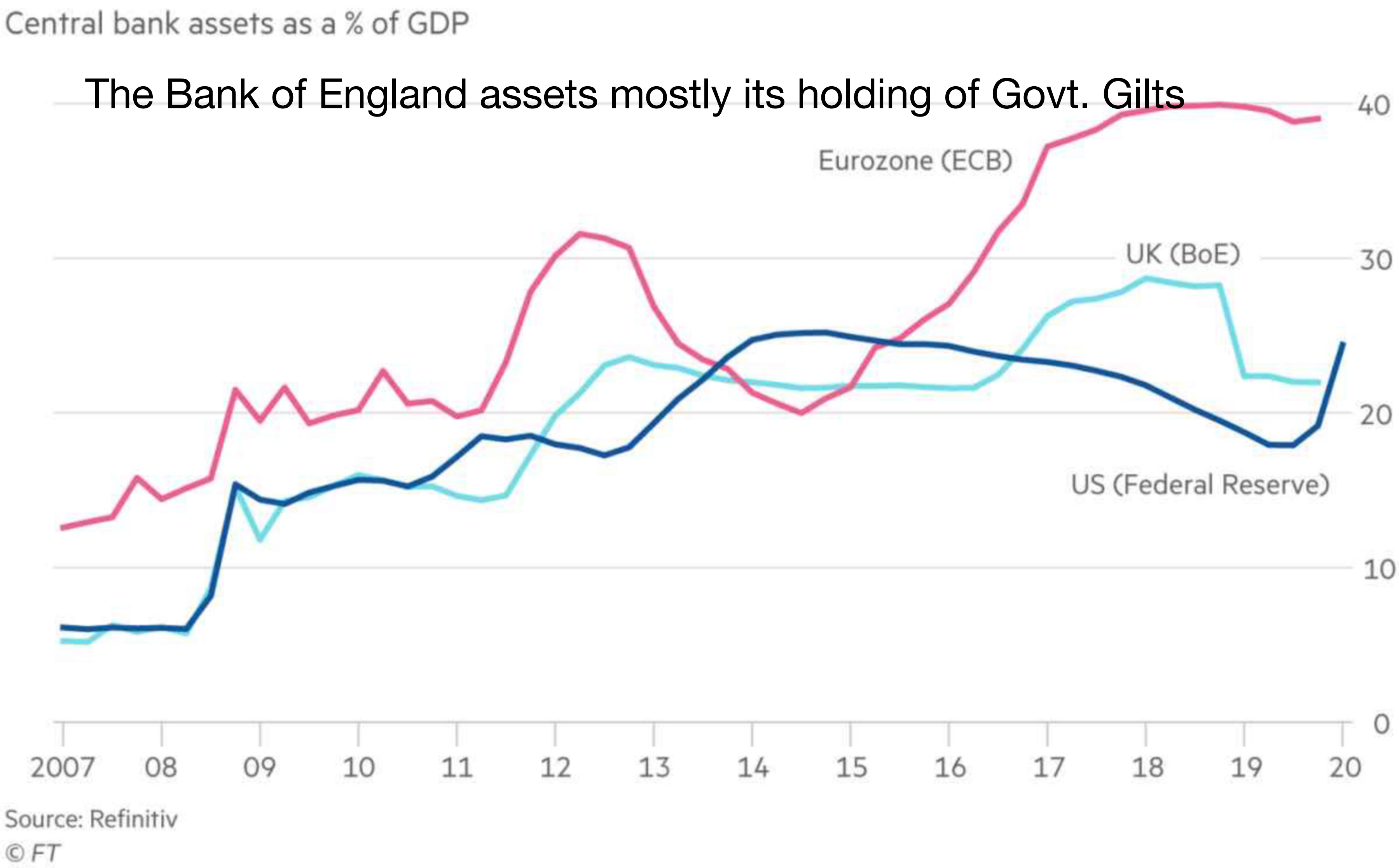


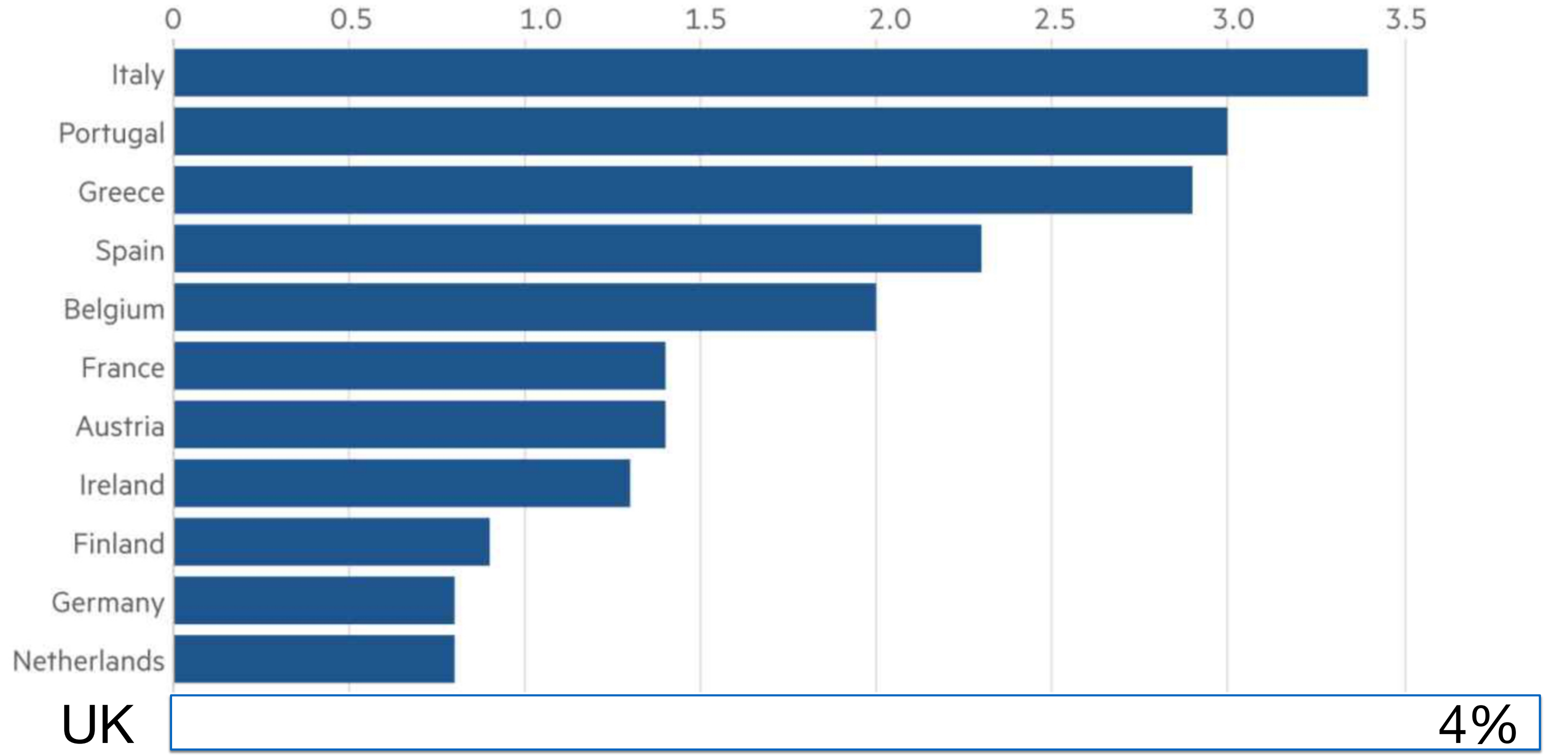

Chart research by Martin Wheatcroft FCA, design by Sunday.
Source: Debt Management Office, 'Gilt issuance calendar - cash raised', 30 April 2020.

The Bank of England assets mostly its holding of Govt. Gilts



## Low interest rates have kept the cost of government debt low

Government debt interest payments as a % of GDP, 2019




Source: Eurostat

## The Exchange Rate

All the major economies are using their central bank to finance
the massive fiscal stimulus:

USA $3trillion
EU $ 0.8 trillion
UK $0.45trillion

The consequence is relative interest rates will not deviate much from current levels unless an individual country experiences an unexpected political upheaval

| | |
|---|---|
| So £-$ | 1.25 |
| £-Euro | 1.15 |

By May 19 concerns over UK approach to Brexit knocked
4% off the above

The current position UK

81% of UK businesses operating

Road traffic 70% of normal

Business is retaining cash and simultaneously borrowing (47Bn)
Part of their wage bill is paid by newly created money from the B of E (37Bn)

There are 28 million households
7 million already get most of their income from the state
( they are pensioners (+2.3% April) or on universal credit (+1K)

21 million households depend on earned income
7 million are furloughed so income down 20% unless
employer tops up

14 million households income stable

# Scenarios

**Lockdown ends by July 1** V

Assumes a peak in new COVID-19 cases for the UK as a whole over by May 1st. And R remains under 1.
Economic activity resumes end May beginning with construction and manufacturing, followed by some restaurants, shops,domestic travel.
In this optimistic scenario, annual GDP growth contracts by 6.6 percent.

**Lockdown remains until October 1** U

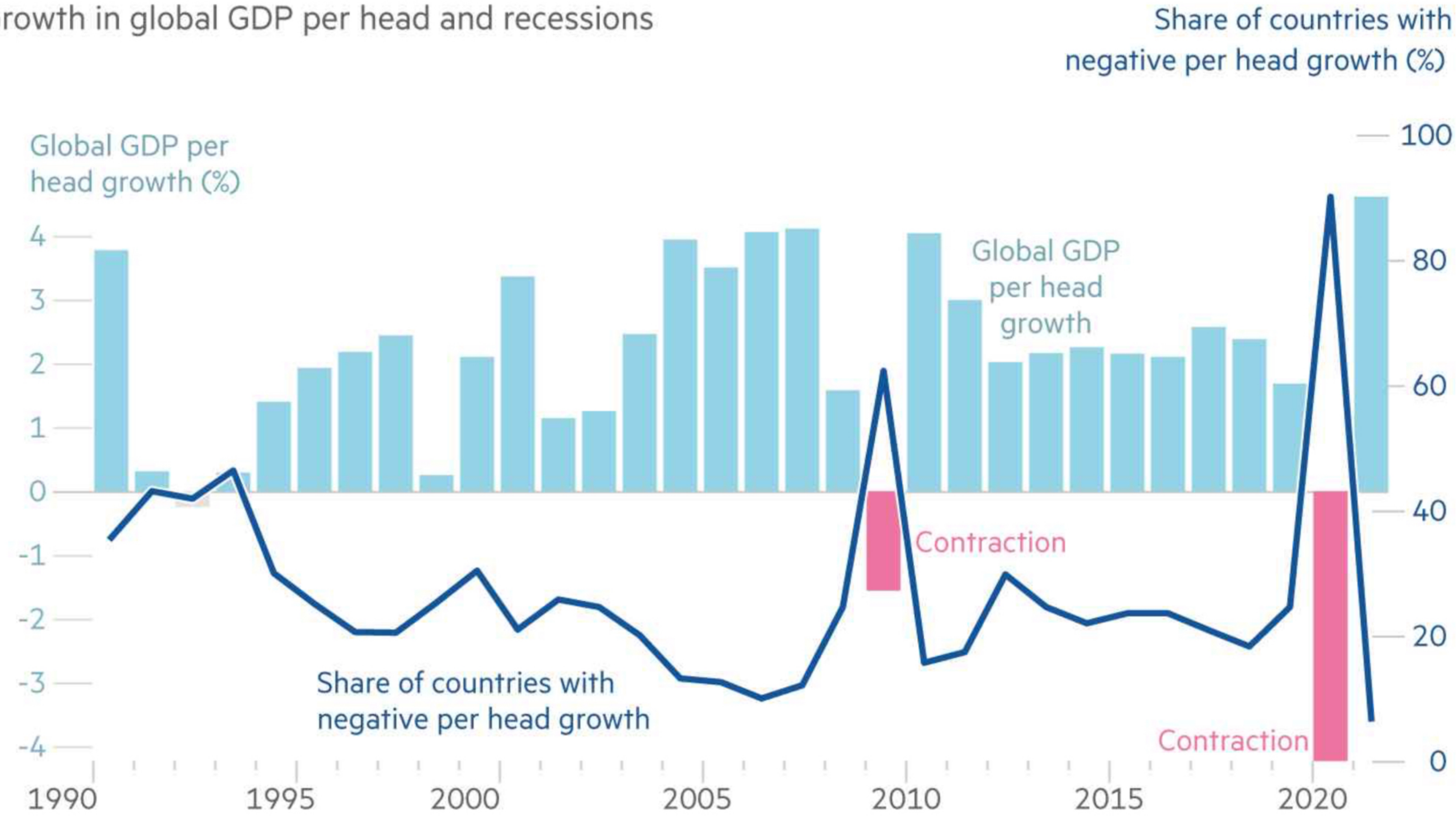
Assumes that the peak in new C cases will take place in early July, creating a deep economic contraction in Q2,
especially for consumption. While we may see a strong recovery in Q4, annual GDP growth will still contract by as much as 11 percent.

**Lock down ends in May, but second peak arrives in October** W or L

Attempts to keep new cases under control in the Autumn fail, requiring the implementation of second lockdown starting in October.
The economy would begin to contract again in Q4, following a recovery in Q3.
Annual GDP growth contracts by 15 percent and business investment remains
subdued throughout 2021 when there would be a weak recovery

## The depth and breadth of the coronavirus recession will be far worse than in 2009 and the recovery much stronger

Growth in global GDP per head and recessions



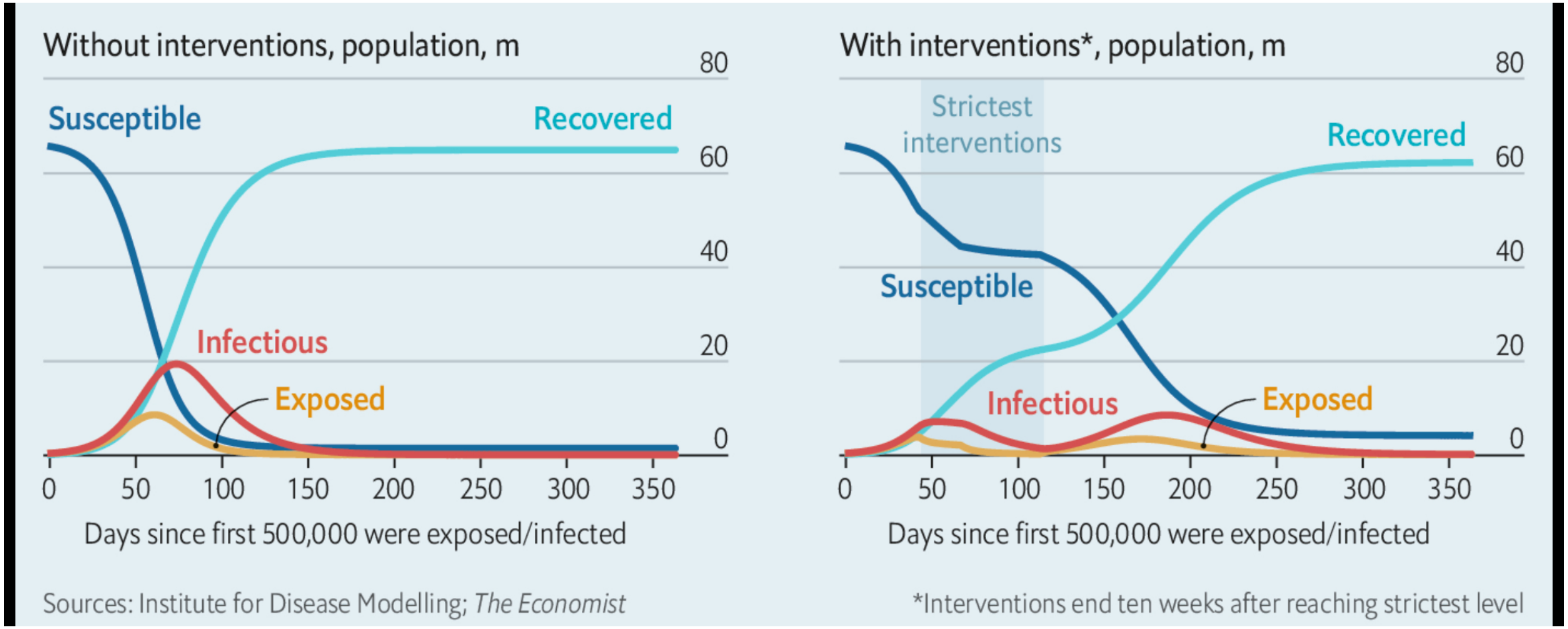

Source: IMF

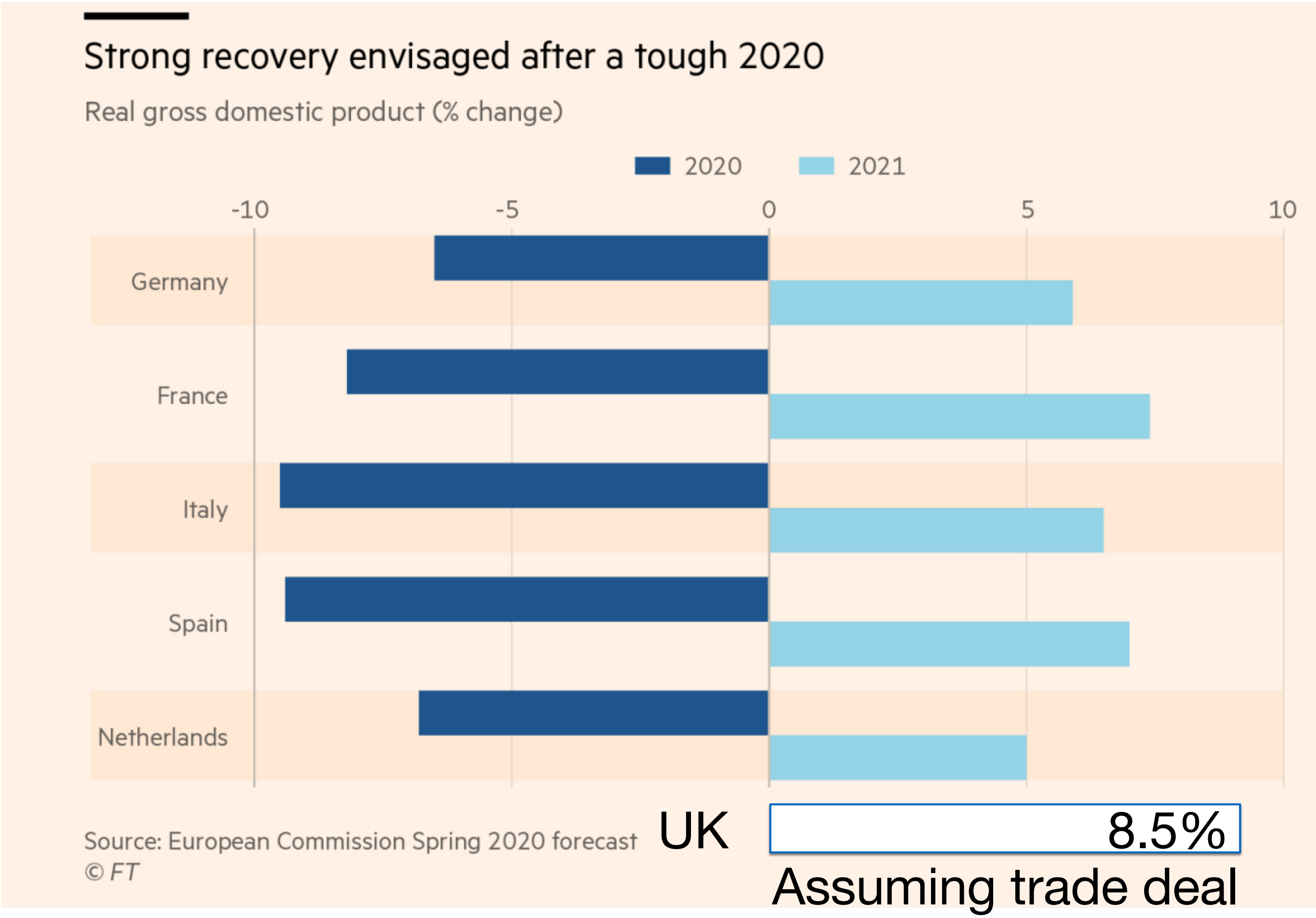
The Government is using the Imperial model

It is 34 years old. Predictive error is significant

There are many coding errors

Second wave doubtful




Strong recovery envisaged after a tough 2020
Real gross domestic product (% change)
2020
2021
-10
-5
0
5
10
Germany
France
Italy
Spain
Netherlands
Source: European Commission Spring 2020 forecast
© FT
UK
8.5%
Assuming trade deal

Currently 33% of the workforce are furloughed or claiming Universal Credit

Key Point: for a third of the economy (lower) income flow NOT created by activity

There is a significant inflationary gap

## The new normal

Much more flexible working from home

Rush hours will be staggered

Government spending as a % of GDP will increase to 42% and remain

Third runway a dead duck

HS2 will be revisited in favour of national electrification

New taxes on wealth above £750K ( property?) and online shopping

Less office space required

International air travel will slowly return (3 years)

Federal Europe finished

More reshoring of supply chains
e.g. Clarke will make desert boots in Somerset not China!

# Post Brexit Tariffs

Currently 47% of imports are tariff free

This will rise to 60% Jan 2021

Imported cars 10% (not if there is a deal)

There will be tariffs on food levied using
a more straightforward system

Average tariff rate will fall from 7% to 6%

# BREXIT

There will be a bare bones deal; no extension

The UK will trade fish for manufacturing

UK will agree to independent panel to show we are keeping the playing field broadly level

The UK will want to ensure regulatory alignment for services

Neither side can afford WTO

Forecast next 18 months

Households will spend their excess cash ASAP

Q3, Q4 2020 significant expansion

As soon as hospitality is opened with 1m distancing  unemployment will fall by a million

Inflation will not take off until April 202,then will run at 4%

Interest rates will remain circa 1%

Real GDP next year +8% ( really!)

House prices up 5%

A 2% Covid tax on wealth over £750,000 possible

No increases in income tax

No second wave

HS2 will be revisited

Third runway will be deferred again!

House prices in prime commute areas will soften

House prices in rural, poorly connected locations with good wifi will rise

Regional air travel will recover but not international

Exchange rates unchanged

$1.25

Euro 1.15

# CONCLUSION

Look beyond the next five months

Because the fundamentals of our system are all set for
8.5% real growth next year (Scenario 1)

The Budget is the most expansionary since the war
the fiscal accelerator pedal is flat on the floor

There will be $12 trillion more money in the global system by year end
equivalent to 6 times UK GDP

In 9 months time your issues will be staff,premises,supply chain
and inflation

And the next challenge will be what kind of trade deal with the EU

You will have to manage higher than expected sales whilst automating
your processes and new ways of working