PROPERTY ACADEMY

PROPERTY ACADEMY PRESENTS

ECONOMIC FORECAST

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Economic Update March 2020 and School Report

As I write this the Coronavirus is upsetting the markets and the unfortunate people in quarantine. It is an example of why all economic forecasts are wrong. The virus is a black swan event and as such, could not be predicted. We can only guess at the potential impact. But positive feedback loops can be very destabilising. A small change in one part of the Global system is magnified by individual responses to it.

The virus creates a supply-side shock due to factory closures and reduced logistics, and a demand-side shock as the conference/trade show/travel/tourism sectors experience sharp falls in volume.

The overriding impact is the impact on cash flow and liquidity.

Talk of fiscal and monetary responses is a natural consequence. Lowering interest rates further will have virtually no impact and cutting tax will not cause those in quarantine, or deciding not to travel, to change their plans. The best thing the Government can do is allow companies to delay payment of income and corporation tax, thus leaving more cash in their coffers.

I hope that Corona will exhibit the usual S curve with a rapid increase in cases followed by a significant reduction in the rate of new infection. The evidence from China suggests their peak has passed. Current indications show that Italy will peak mid-March, and the UK mid-April.

So far it is not as serious as flu which has infected 30 million and killed 17,000 so far this winter (in the USA), although of course it is exhibiting a higher mortality rate at 1.5-2%. Some evidence suggests that 9 degrees C is the optimum temperature for viral replication. And high temperatures significantly reduce the rate of infection (although there is also evidence to the contrary). We must hope for a warm spring – if only because the NHS will be better placed to cope with hospital admissions if it is not also trying to deal with the normal number of winter flu patients.

My opinion is we shall see a strong bounce back in Chinese and global output by June and by September global activity will back on trend. Overall impact will end up displaying a V shape the current rapid downturn followed by an equally rapid upturn all within the next 6 months.

Then in the UK and EU, focus will return to trade negotiations. The UK Government is demanding freedom to decide on its own regulations, regional aid, and environmental standards. The EU is saying this means only a limited trade deal excluding services can be agreed. British business knows that the Government is posturing to appease those who voted leave. Any exports to the EU regardless of Government policy will have to be CE compliant. The EU will ensure there are border checks to ensure the UK doesn't become a source of sub-standard products.

On the issue of regional aid: the parts of the UK the Government will wish to support are eligible under EU rules as it is. So no change there.

In short, a deal will be done in time. From Jan 1 2021 the UK becomes a third country outside the single market. Northern Ireland effectively remains within the single market with border checks on ships and or at entry ports (remember this was non-negotiable a year ago!)

Right,
Let's get the school report over with!
This is what I said last year for the UK.

FORECAST	**2019**	**ACTUAL**
Real GDP	1.1%	1.1%
CPI Inflation	2%	1.8%
Unemployment	3.8%	3.8%
Exchange Rate Index	77	82
Average House Prices	+2%	+2.2%
Interest Rate	0.75	0.75

Working on a simple % I was 66% correct.
Headmaster's comment from 1965 *"at last this boy is showing some promise"*

Forecast for end 2020 and end 21

	2020	**2021**
Real GDP	1.8%	2%
CPI Inflation	2.8%	3%
Average Earnings	4%	4.3%
Unemployment	3.8%	3.6%
Exchange Rate Index	83	86
Average House Prices	+5%	+6%
Interest Rate	0.75	1.25
Year End £	$1.35	$1.40
Euro	1.23	1.26

These forecasts assume the following:

1 There is a free trade deal with the EU
2 Trump wins
3 Oil price of $60 per barrel
4 Coronavirus spread is minimised by June 2020
5 No new pandemic
6 No new wars in the Middle East

The key driver of economic activity in any country is the growth in their domestic money supply.
I expect bank lending and the money supply to expand steadily over the next 18 months. It is this which will drive up house prices, perceived wealth, and consumer confidence. Meanwhile, employers will continue to face labour shortages, driving up base salaries and bonuses.
NB the money supply growth rate has doubled since the end of 2018.

I derive my forecast for GDP growth and inflation from the money supply data. I expect the flow of new money into the economic pipe to expand steadily. The reason is straightforward. Real interest rates are either zero or negative. Banks are shareholder value driven. Thin margins require more volume to obtain target ROCE. British banks essentially are Walmart operations (with the customer care to go with it!)

In 2019 Walmart's net margin was 2.48%. The average net interest margin of UK banks was 2.6%. Low margins require large volumes. Mortgages will remain very competitive as banks compete for volume and market share.

The Number One Indicator

Today's Money Supply determines Nominal GDP in two years time

I expect the number of housing transactions to be 10% higher by June. January was up 5.6% compared to the same time last year.

Money supply growth increases perceived wealth via house price growth (expect 5% this year).

This should spill over into retail sales. January 2020 volume was up 0.9% on December 2019 which itself was 1.8% higher than a year earlier.

The data we have to date indicates a small but significant increase in velocity. The virus will reverse this in the UK for March, April and possibly May. I would expect June to show a big upturn which builds as the year progresses.

The UK Budget

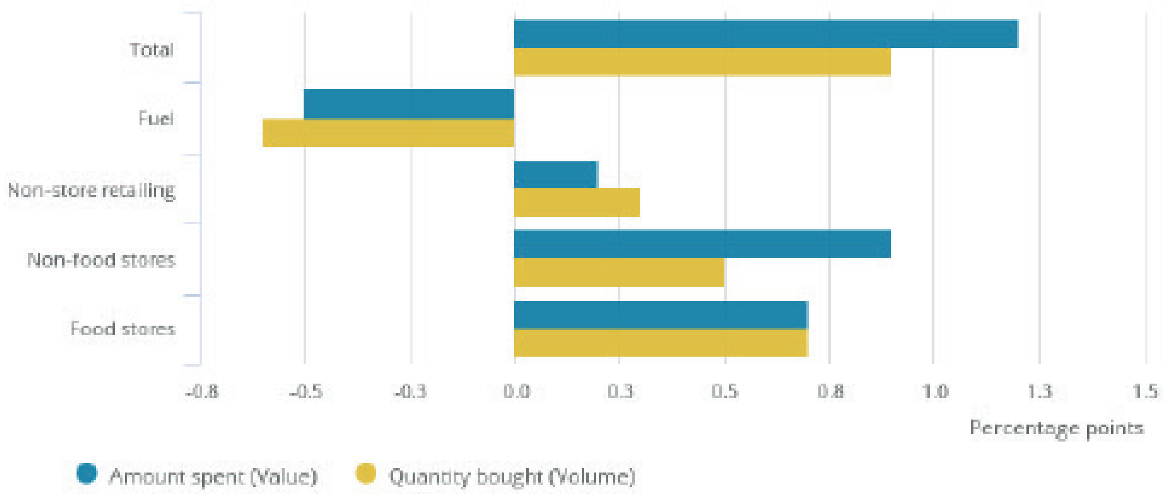
The new Chancellor delivered an expansionary budget with some style and humour. It was clear that the Government intends to deliver one nation Toryism based on expanded public services, support for SMEs, and with less emphasis on London and the SE. And there is more money to support and expand FE colleges (at last!).

To offset the impact of Coronavirus there is a package of measures which could cost up to £30 Bn. Of note: business rates are abolished for one year for SMEs in hospitality and leisure sectors. A loan guarantee scheme for bank lending up to £1.2m for SMEs. Any sick pay given by SMEs will be refunded by the Treasury. And micro businesses which pay no rates will get a cash grant of £3k.

Over the next 5 years nearly £200Bn will be spent on infrastructure. This will be mostly borrowed by selling Gilts to insurance companies and pension funds both based in the UK and around the world. The interest on this debt will be paid out of current tax receipts.

Figure 3: Fuel provided a negative contribution in January 2020 despite an overall growth in both the quantity bought and the amount spent

Great Britain, January 2020 compared with December 2019



Source: Office for National Statistics – Monthly Business Survey – Retail Sales Inquiry

Surprisingly the OBR think the real GDP will only grow 1.1% this year and 1.8% next year. I think they are too pessimistic. I think 1.8% this year and 2% next. I repeat why: money is free now, the B of E has effectively expanded each UK Bank's capital base by 2% by suspending the capital buffer rule. This will allow the creation of £200Bn new money. The budget will have injected around £50Bn by this time next year. The monetary and fiscal stimulus is significant. Both money entering our pipe and the rate of flow through the pipe will be increasing.

Because of this I think inflation will be higher than the Treasury 2%.

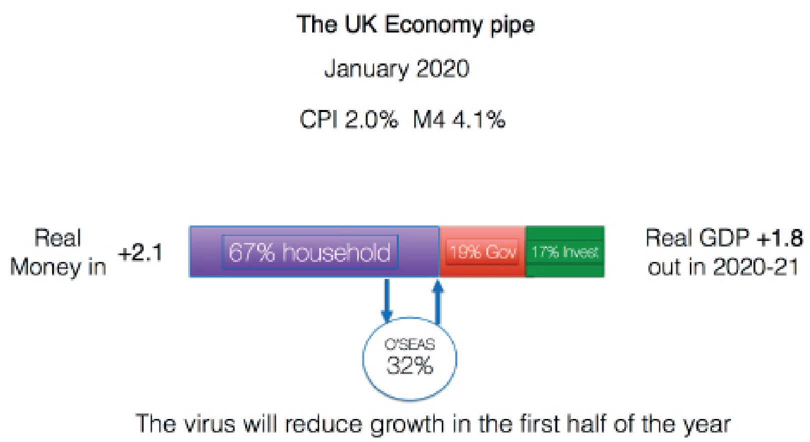
It is now clear to me that Coronavirus will create a V in the first six months of this year: the spend and output lost in the first half will be more than made up in the second half.

The Rest of the World

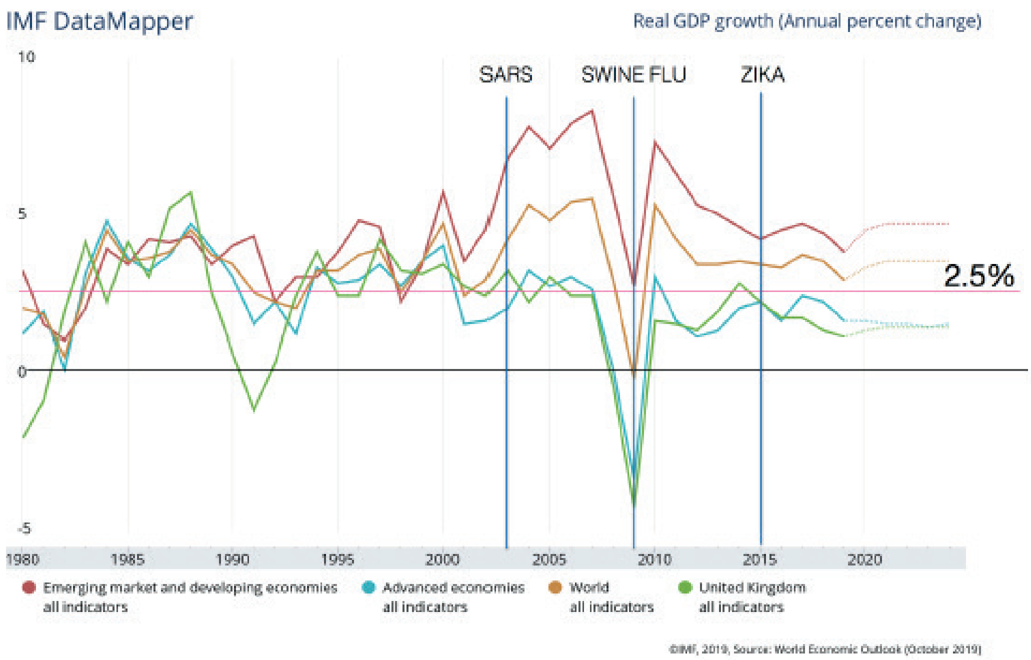
"We have nothing to fear except fear itself."

When FD Roosevelt said this in 1933 the US banking system had failed, there was mass unemployment, the great recession had begun.

None of the conditions which created the great recession are in place today. Money supply growth in all the major economies is sufficient to drive stable growth. New money is also in effect free as



the inflation adjusted interest rate is zero or negative. This means real estate and equity prices can and will only increase. This will further increase inequality of wealth but ensure populist leaders keep their job. It's the economy, stupid!



The advanced economies are all expected to grow around 2%. This lower average growth compared to pre 2000 is because of ageing populations and, putting it bluntly, a lack of innovation as the majority feel secure and comfortable sitting on rising asset values. Emerging market economies have younger demographics, much less in the way of fixed assets, and therefore a hungry, adaptable workforce keen to experience the life styles they see in the rich countries. Hence real GDP growth averaging 5%.

Please note that previous pandemics did not kill global growth. Swine flu coincided with the financial crisis in 2008. Coronavirus is respiratory, there is no vaccine, and it adversely affects the very old. For the vast majority it feels like mild flu. I read that economists are advising that it could halve global growth. This is extreme. The rate of infection in China is now almost zero. So whilst Italy peaks, China recovers. I do not accept that world trade will halve.

The so-called Oil Crisis

The oil crisis is media comment. It is not a crisis: it is a price war between Saudi Arabia and Russia which will end when one of them blinks (probably Russia).

A sharp drop in oil price, if sustained, will boost global purchasing power. It is a problem for oil exporting countries but a big benefit to oil importing countries. Three quarters of the world's population will benefit from lower oil prices.

A more accurate headline: Oil price drop set to stimulate global growth!

Conclusion

I have looked at the major economies using my framework of money and velocity. All are set fair. Coronavirus will cause short run drops in velocity in the affected countries but I firmly believe this will be short-lived and disappear when the warm weather arrives.

In my opinion Central Banks have overreacted (and rates will rise again in the second half of this year) but the UK fiscal response is timely and will prove effective.

Unusually for me, I am optimistic. I now believe the global slowdown which began two years ago is over. We have experienced the classic soft landing after an eight year expansion. The behaviour of the stock market is no indicator of human sentiment, it is a reflection of how algorithms are structured. And I expect the markets to be back at the early Jan level by July.

I hope when the school report is written is 12 months' time the Headmaster will be able to say the promise shown a year ago continues and we are seeing significant improvement!

Prepared March 11 2020

Roger Martin-Fagg

Roger Martin-Fagg is an economist turned strategist.

A behavioural economist who focuses on behaviour and feedback loops which are largely absent from conventional models.

He began his career in the New Zealand Treasury, then moved into Airline Business Planning and teaching postgraduates all aspects of economics. He designed and ran the postgraduate diploma in Airline Management for British Airways before joining Henley Management College in 1987, where for 21 years he taught senior managers macroeconomics and strategy.

Roger is an independent teaching consultant. He has been external examiner to Bath University, worked with the Bank of England, three of the major UK clearing banks, advised a major London recording studio for 15 years, and regularly talks to SME owners in the UK and Europe about economic trends. He is a visiting fellow to Ashridge, Warwick and Henley business schools.

Roger is a practical researcher. He focuses on how the economy really works and on the links between FT100 reward systems, the behaviour of banks and economic instability. He also researches his clients trading environment as a necessary component of his teaching. His book

"Making Sense of the Economy" is in its fourth reprint.

He speaks at conferences around the world on the economic outlook and its impact on business. His quarterly Economic Update is sent to 1,200 SMEs.

Roger is one of over 70 experts that works with the Property Academy's members. Want to find out more about the benefits of Property Academy membership and attend a free trial meeting?