Economic Update April 2024

VISTAGE

Written April 2024

Economic Update

Written by Roger Martin-Fagg, Behavioural Economist and Vistage Speaker

'UK SME confidence remains optimistic but there are economic challenges ahead'

Roger Martin-Fagg
Behavioural Economist & Vistage Speaker

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

Dear Vistage member, welcome to my update!

The purpose of the update is to act as a counterweight to the general economic commentary you get from the media. As many of you know I look at the economy through a behavioural lens. I focus on money and how it flows. As I explain in this update, this is missing in the mainstream models which are widely used by mainstream forecasters. Many of you have heard me say that these models and forecasts are precisely wrong. My approach is broadly right. It's your choice!

I am naturally optimistic (as most of you are!). As a consequence I tend to accentuate the upside and choose the data which supports my natural inclination.

If you are a pessimist there is a huge amount of analysis and commentary out there to support your mindset.

My optimism is always justified when I spend time with you. Vistage members are thinkers and doers simultaneously. Your adaptation to the reality of lockdown has been remarkable and I know many of you are producing financial results well above plan. As you are 60% of the economy my optimism is justified by your behaviour. Please continue to train, invest, innovate and lead. My forecasts will then prove correct!

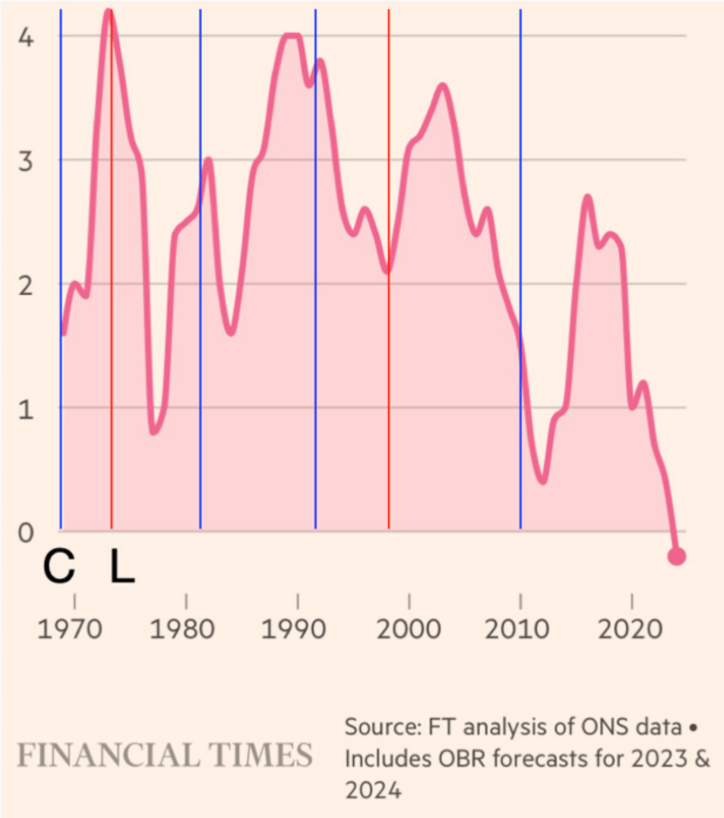
Roger Martin-Fagg

In previous updates I promised to give context for the choices the UK voter might make over the nine months. I have no doubt the majority will be unaware of the data and will vote according to family tradition, instinct, or not at all. Some might read the manifestos and discover they all basically say the same thing with slightly changed emphasis. The Party of low taxes will probably state they have with the budget, begun the progression to lower tax take. The data will show this to be untrue as fiscal drag will negate the tax benefit within a year.

We must first distinguish between income and wealth. Income is what you can buy stuff with, it's totally liquid. Wealth is the value of any real assets you posses ie house, artwork, wine cellar (I wish), share portfolios. To spend wealth, you have to either borrow with it as collateral or dispose of it for cash. When we were young (ie under thirty) we focused on income rather than wealth, then as the saying goes, we begin to settle down and a much bigger chunk of our income goes on obtaining a property, so we begin the process of accumulating wealth.

We begin by looking at the change in real after-tax incomes in the UK. The average growth since 1970 has been 2.1%. But since 2005 it has averaged only 0.73% pa. Please note that in 2005-10 it was only 0.9%. This was at the height of the property boom under Blair/Brown. In comparison, at the height of the Thatcher property boom in 1988-90 it was growing at 3.9% thanks to Lawson introducing 40% as the highest income tax rate. If we assume rational behaviour, that voters are entirely selfish, then on an after-tax real income basis, the Tories should have won the election in 1973, Labour should have won in 1979, the Tories in 1993, Labour in 2010 and clearly they should win this year. Let's now consider wealth.

Average annual change in real household disposable income over previous five years (%)



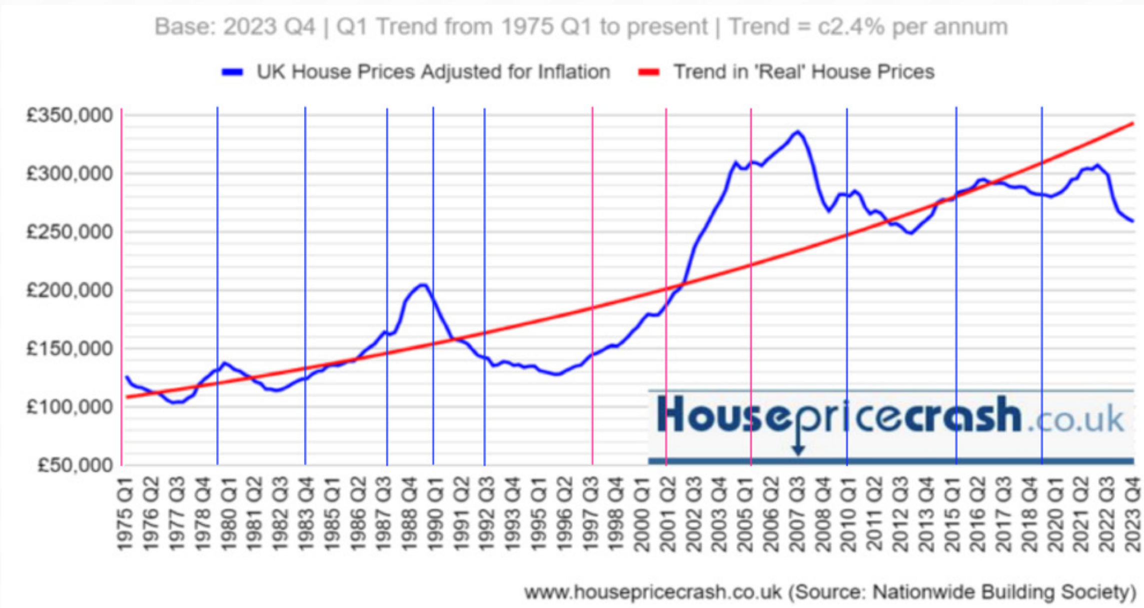
52% of household wealth is the value of their house. 30% is in their pension, 14% land, 4% non- pension equities.

Since 1970 the real price of the average UK house has risen by 2.6% pa compared to real disposable income growth of 2.1%.

The FT 100 share index has existed since 1984, since then it has shown an average annual real return of 3.4%. We can conclude that real growth in wealth has been higher than income. And in the UK, it is taxed more lightly than incomes. Look at the real price of the average house chart.

Assuming rational selfish voting then Labour should have won in 1979, and the Tories should have lost in 83, 92 and 2019.

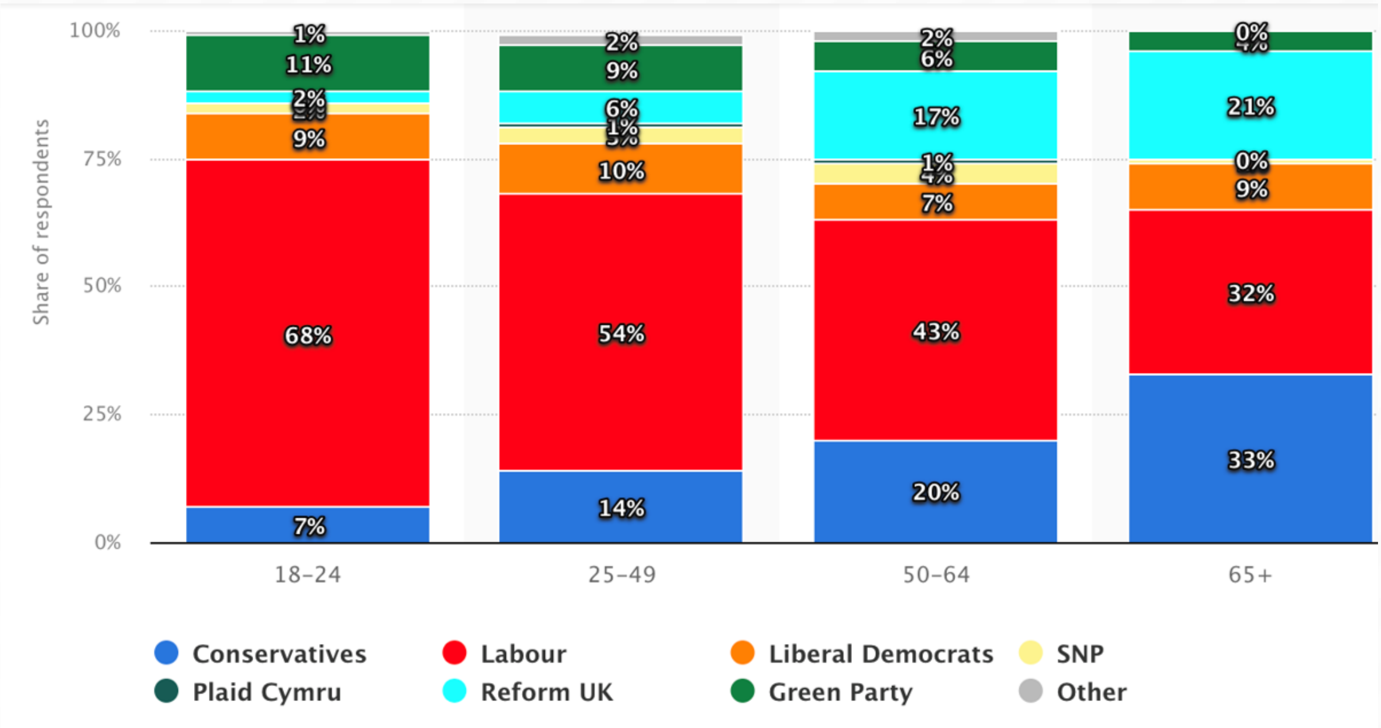
Real House Prices



If we consider non-fixed asset wealth ie equities, performance varies widely. I have taken the St Jame's Place balanced portfolio. It was launched in 2011. It grew at an average annual rate of 4.5%. The inflation rate averaged 2.8%. The real return after tax (it is an ISA wrapper) is on average 1.7% pa.

If we look at the whole UK stock market since 1970 the real return on equities has been 4.6%.

We can conclude that since 1970, equities have performed best at 4.6%, property next at 2.4%, and real income after tax last at 2.1%. We can also conclude that people aged 20-35 have not enjoyed the increases in wealth or incomes that their parents enjoyed.



Statista 2024

Here is the latest data on voting intentions by age. The under 49-year-olds are not impressed by right wing manifestos. If they have some form of higher education, they voted remain.

The consequences of Brexit were disguised by the substantial Covid and energy subsidies. But the economic consequences are shining through now.

Cambridge Econometrics has calculated that the average Brit is 2k worse off since Brexit. And the average Londoner 3.4k worse off.

If you consider the chart on the percentage change in real median earnings it shows that that median earnings have fallen 16% in London since 2008. And the only part of the UK still in the EU which is NI is performing best of all.

Now let's look at the finances of the UK.

The chart from the OBR at the bottom of the next page tells us the following:

Compared to other rich countries we are undertaxed. Government has borrowed instead of raising taxes. As a consequence, we have one of the largest budget deficits, and one of highest net debt positions. We are the blue bar. The excuse is Covid and energy support. But of course, all the other countries suffered from Covid and high energy costs, particularly in the EU.

Brits under 30 years old have never experienced anything other than a Conservative government. They feel their income is heavily taxed, whereas their parents' wealth is lightly taxed. Their parents most likely voted leave. Freedom of movement is important when young. This has been curtailed.

The Economist has built a model based on a survey of 100,000 adults to show how the electorate might vote. The key findings are as follows.

Only 4% of the 51 million adults are more likely to vote Tory than they were in 2019. They are from unusual groups. Older renters in the SE, rural British Indians and young Bangladeshi homeowners.

The classic red wall voter is a white man living in the NW aged 55-64. There are 430,000 of them. They mostly voted Conservative in 2019, but are now twice as likely to vote Labour whilst being tempted by Reform UK. One of the reasons is levelling up failed to materialise.

This pattern is being repeated in the Western world. Low income, less educated blue-collar workers are now less likely to vote along class lines.

Then we have 'Stevenage' woman. About 160,00 of them. They are middle-aged working women with a mortgage in a suburban town in the SE. In 2019 they were twice as likely to vote Conservative, now it's Labour. They are not ideological, they just want competence.

In Scotland the less educated in the cities are likely to swing from SNP to Labour.

For each month the election is delayed 133,000 voters will face an average monthly increase on their mortgage of £288, the legacy of Truss. The swing to Labour is the biggest with South East mortgage holders. In the SE real median incomes have dropped 11% since 2008.
So we should assume Labour will win.

It will inherit a public sector in dire straits, a country with big deficits and an interest bill which takes 10% of tax revenues. Steering between social conservatives and young progressives will be a challenge. The left will challenge. The wealthy elderly in the SE will challenge.

A Labour government has stated they want to get real GDP growing at 2% and this will allow them to deliver a sustainable fiscal stance.

This will require a combination of three factors: growth in productivity, a labour force willing to increase average hours worked, and real government spend to grow below real GDP growth. Raising productivity is the route to higher growth and sustainable public finances.

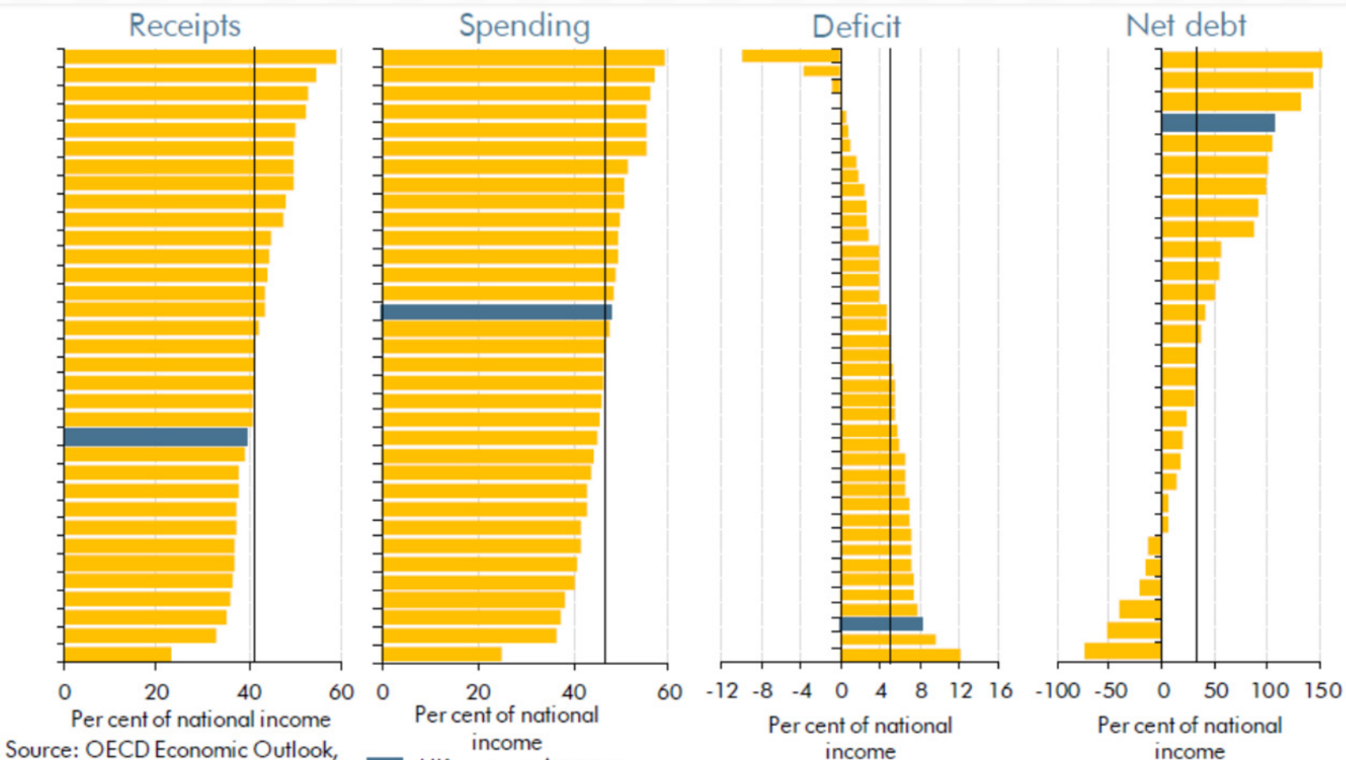
If the UK could return to the productivity growth rate we enjoyed before 2008 which was 2% pa then the debt to GDP ratio could be 5% lower and falling, and the national debt £150bn smaller.

But can the government raise productivity? Higher public sector net investment may help: pushing for net zero will produce GDP in a greener way but will it increase the growth rate? Large scale infrastructure spend does not have a good track record for timely delivery and cost management.

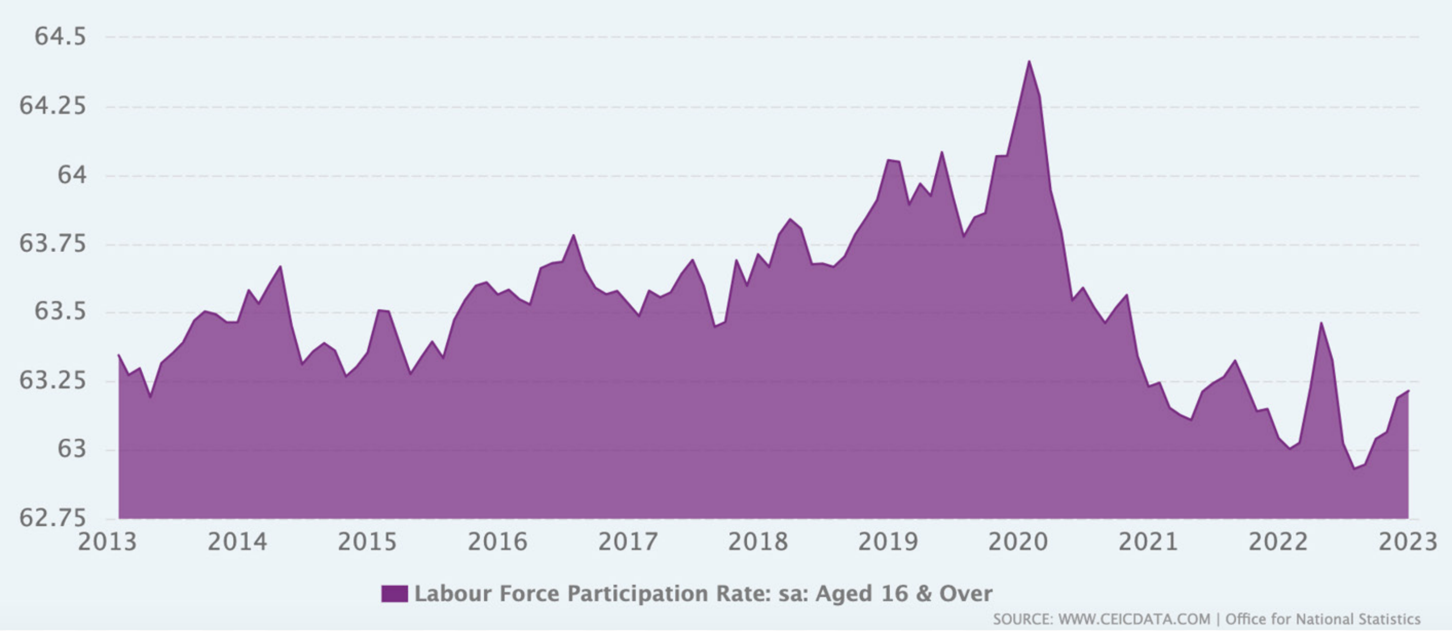
Faster growth in labour supply plus increased participation would certainly deliver. If we ramp up net migration then there is a boost when the immigrants are young. However, when they age and breed the demand on the public purse grows.

When in the EU, we benefited from millions of young EU workers who came to live and work, paying tax. Many decided to settle, more returned home after a few years.

Ideally work visas would grant people without dependents with say a max 5-year stay.



Source: OECD Economic Outlook, November 2022 (2021 outturns)



The UK participation rate is those between the age of 16 and 64 who are receiving a wage.

The rate has fallen since the end of Covid because of early retirement. The big dip 18 months ago is because 500,000 retired early. As you can see from the graph, inflation has driven some back into work. If a youngster joins an apprenticeship scheme he or she is actively participating.

Since 1990 the actual hours worked has varied within the range of 38.1 hrs per week in 1992 to 36.7 last year.

The total number of work visas granted in 2023 is 585,000 plus 285,000 visas for dependents. There were 78,000 temporary work visas granted mostly to workers from the Stans eg Kyrgyzstan.

50% of all Brits between 60 and 65 have now retired.

There has been a surge in sickness benefit claimants. This is because sickness benefit pays more than unemployment benefit.
The OBR estimates if the approval rate for sickness and disability benefits had remained at 2016-17 levels, 670,000 fewer claims would have been approved for these benefits in the ensuing years.

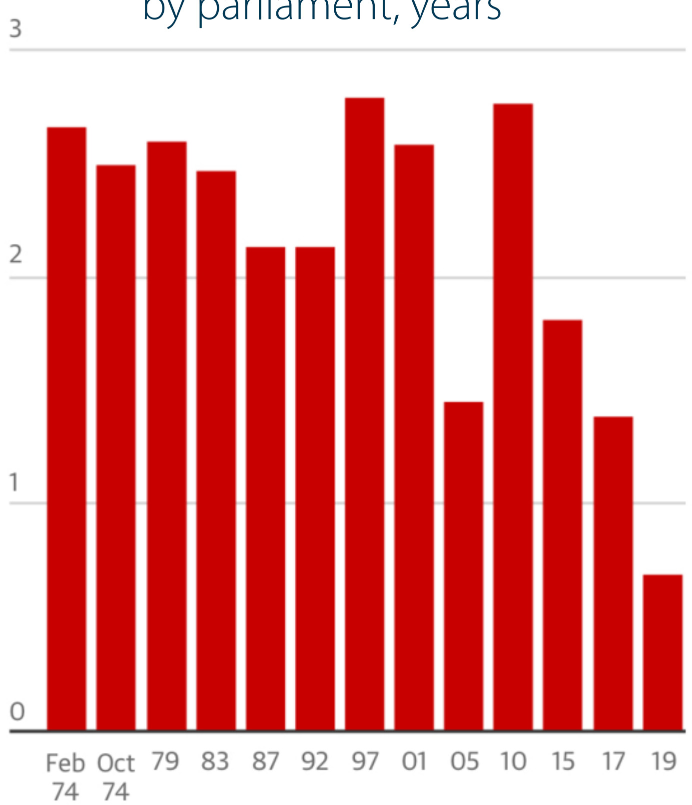
Last year the work visas granted matched the early retirees. So the labour market is still very tight. Any business needs to focus on being an employer of choice, offering above market rates is unlikely to be enough to attract and retain in the long run.

In addition, home grown labour will barely increase. With no net migration increases the labour supply deteriorates significantly from 2029, improving again after 2035.

There is a sense that the nation has lost its mojo. Our political leadership (or lack of it) is a key factor.

All the research tells us that entrepreneurs and corporates wish for political stability above all else.

Average ministerial duration by parliament, years



Guardian graphic. Source: Strong and Stable

We can see that since 2019 the average time in office for Ministers is just eight months. No wonder there have been policy flip flops and nothing much has been achieved.

The biggest stimulus to growth will be ministerial stability in post. The senior civil servants will have time to educate on the trade-offs and begin to implement policies which will bear fruit 3-5 years in the future. Starmer is talking about a ten-year renewal plan which is exactly what is required.

Consistency is key. Once business leaders feel they can read their trading environment with some confidence investment will take place regardless of the rate of interest.

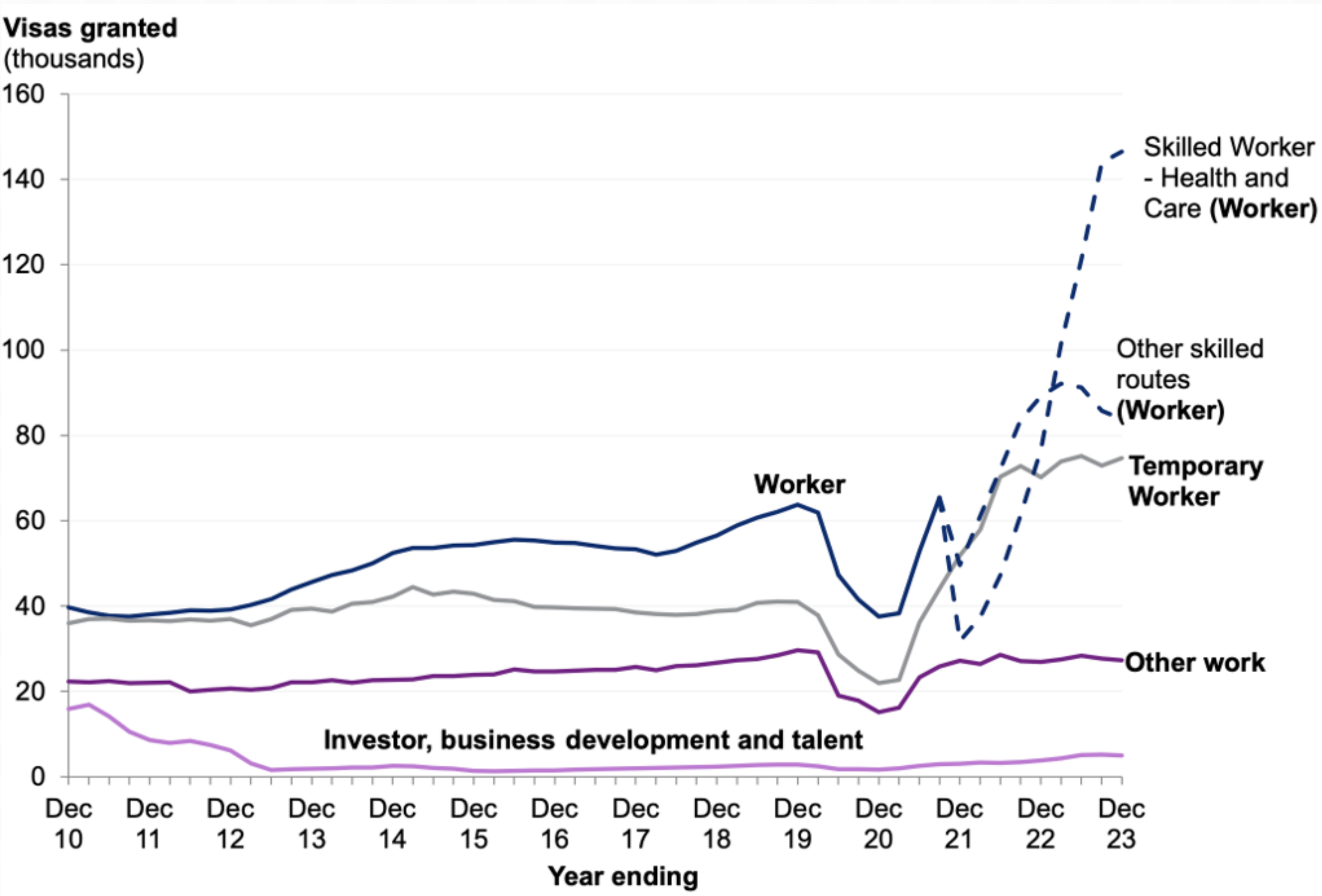
If Reeves adds software purchase to the list of CT deductibles it will speed up AI and productivity improvements. But it will probably cost the Treasury circa 5Bn and like the R&D tax break there will be some dodgy claims.

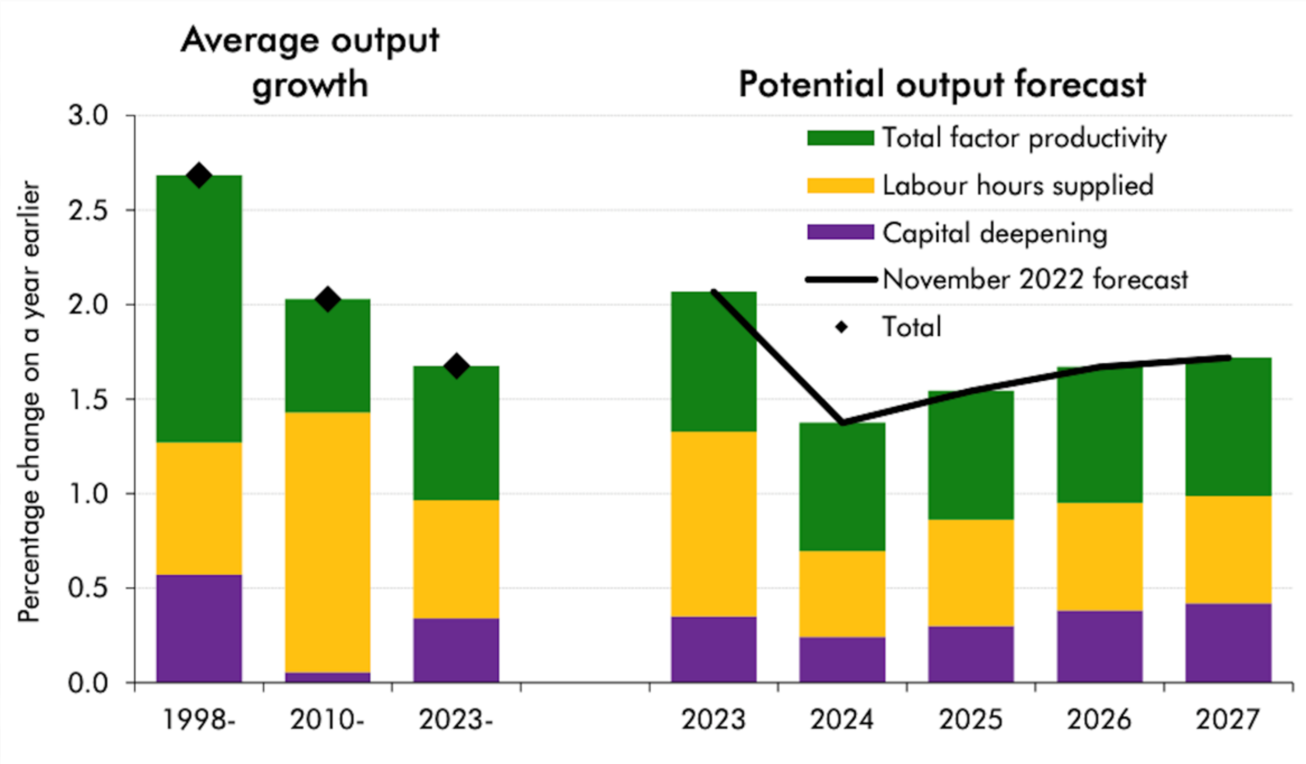
Anyone who runs a business will know that growing it (unless buying a competitor) is a grind that requires continuous incremental change. It is seldom achieved with a big bazooka.

I expect a change in government. And I expect an improvement in the attitude of the nation. The labour supply and underinvestment issue does place a ceiling on our potential growth rate. It's probably 1.8% pa real. With current tax rates, this would allow more investment in the seriously diminished state provision of justice, infrastructure, education and health.

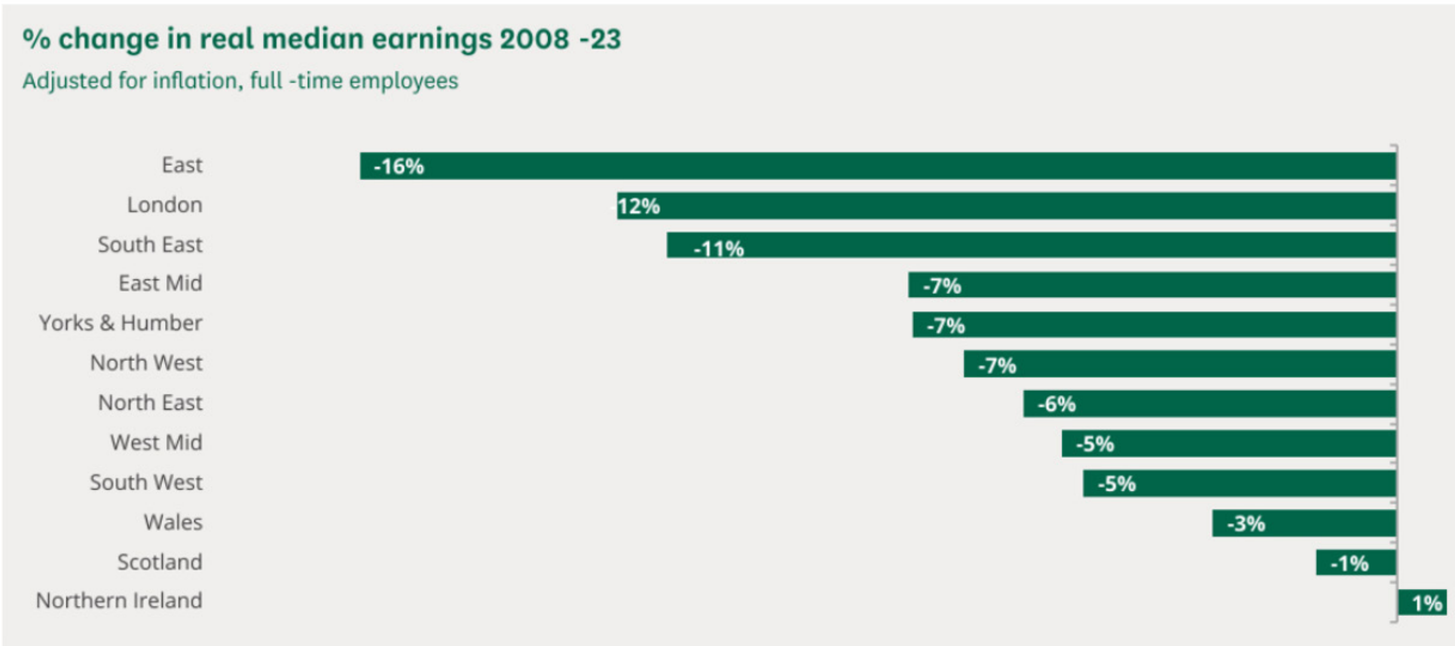
It always makes sense to borrow for investment so long as the return on the investment is larger than the cost of finance. The next chart is the opinion of the OBR. The main contributor to increased output over the next five years is assumed to be investment spending by both the public and the private sector. Please note labour productivity is only forecast to increase a bit.

These are forecasts and all forecasts are wrong. It could be better or worse. However. these forecasts do underpin government choices.





The consequence of underinvestment is a decline in real wages. The chart shows that every region of the UK apart from NI has experienced significant reductions in real median earnings.



Source: ONS, [Annual Survey of Hours and Earnings, 2023]

There is a widespread view that due to generous welfare benefits it pays not to work in the UK.

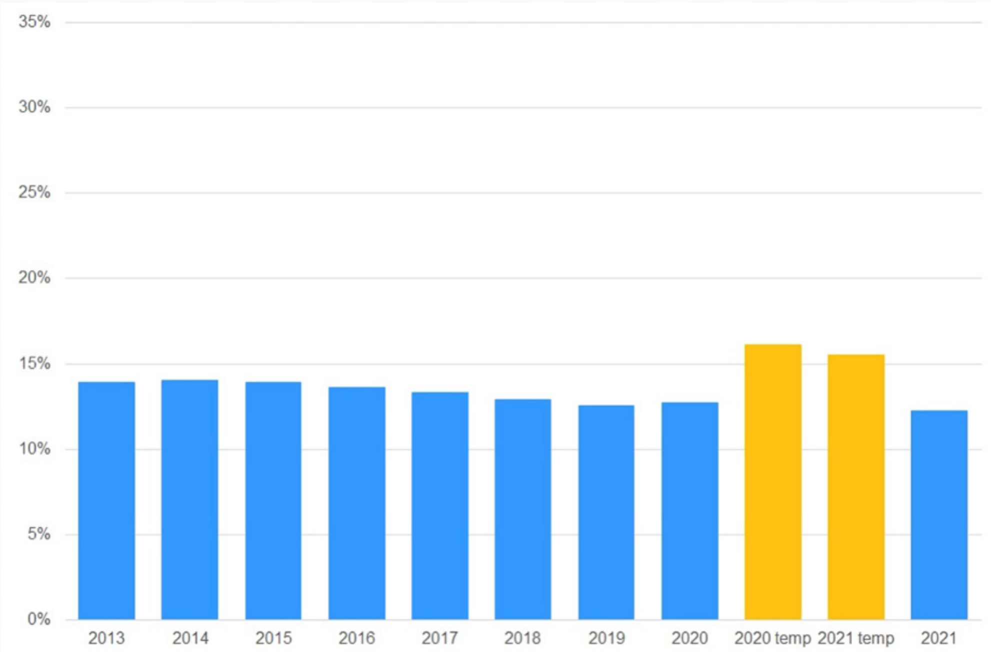
The evidence does not support this opinion.

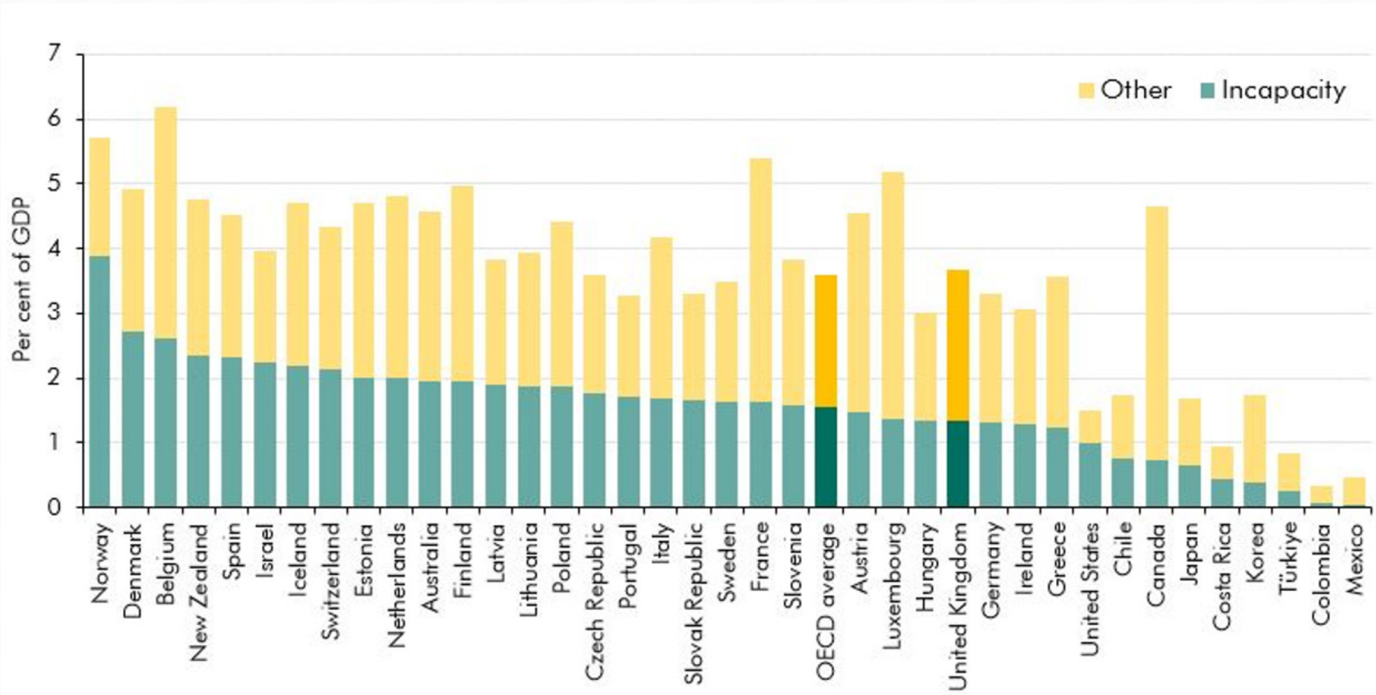
UK benefit reforms in recent decades have resulted in higher employment than the system they replaced. The jobs are part time, low-paid, and rarely lead to career progression. As a result, those employed are mostly on low pay, paying little or no tax and often still being entitled to in-work benefits. The average paid is £8,000 per year (2021 prices). Virtually none earned over £20,000 per year. All the new workers were in the bottom 40% of the overall earnings distribution. The universal credit allowance amounts to £4,545 a year.

Universal credit includes the following: housing allowance, bringing up children, caring, sickness and disability. 9% of the UK population claim universal credit. 39% of these are in work so do not claim unemployment benefit which is £4,500 pa. 18% of the population receive a state pension. In combination 27% of the population are living off the state.

If we compare the UK to other rich countries and exclude pensions the chart shows that we redistribute 3.8% of GDP in benefits, a bit above the OECD average. Canada, NZ, Australia and the Nordics (excluding Sweden) are more generous. The UK spends 5.2% of GDP on pension transfers.

Monthly Universal Credit standard allowance for a single person over 25 expressed as a ratio relative to median earnings since 2013





Note: We estimate public spending on cash benefits for *non-pensioners* by subtracting 'old age' and 'survivors' spending from total cash benefits spending.
Source: OECD, OBR

The prospects for this year and next year.

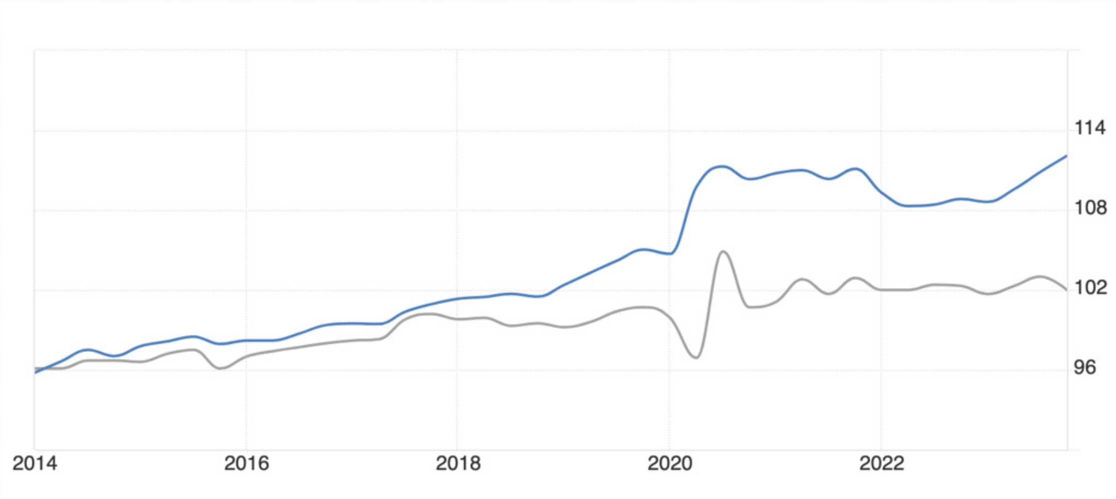
The USA

It's election year. If it's based on the economy, Biden should romp home. The USA unemployment rate is 3.9%, its GDP growth rate 3.1%, inflation is 3.2%, interest rates are the same as the UK at 5.25%. The stock market is up 10%.

Regrettably the challenger has a single objective which seems to be to save his business empire and stay out of prison. Thus, his rhetoric is full of nonsense and magnified by social media. Consequently, Trump will probably win.

It's too early to say what the implications will be for the world. History indicates that 90% of his pledges will evaporate. Meanwhile the Biden Inflation Reduction Act continues to attract global inward investment at a record level.

Looking ahead the USA has significant potential given the rate of investment and the growth in productivity. The chart compares UK productivity with the USA. Notice we began to diverge in 2017. The USA is the blue line.



Biden's appoval rating declined with falling customer sentiment, but he has not benefitted from the rebound in economic perceptions

China

China is growing at 5.2%, inflation is 0.7%, Unemployment 5.3%, base rate 2.2%.

China is at a turning point. The massive real estate and infrastructure boom has petered out.

Investment in areas such as the construction of new factories has tapered off, companies have also downsized or ended their operations in China. The growth model of reform and opening up, which succeeded in bringing in foreign investment and improved the quality of output, has reached a major turning point. Foreign direct investment fell by 80% in 2023. Xi has been slow to react and China risks deflation. Trump has promised a 60% tariff on all Chinese goods and a total ban on Chinese electric cars if elected. China will not collapse, the government owns too much of it. However, it would seem too much effort is being placed on ensuring communism dominates rather than a healthy mixed economy. Foreign direct investment has every reason to go elsewhere.

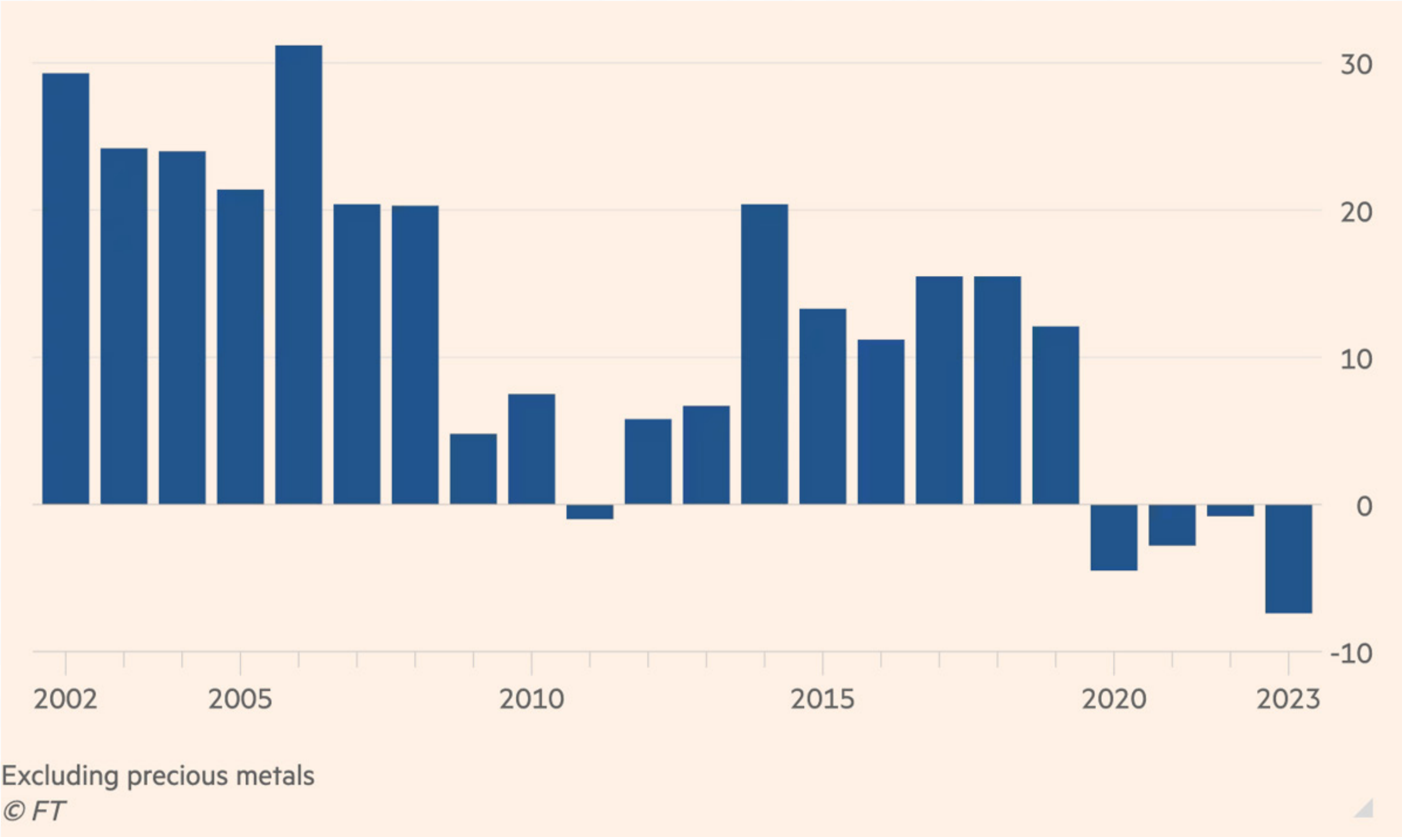
The EU

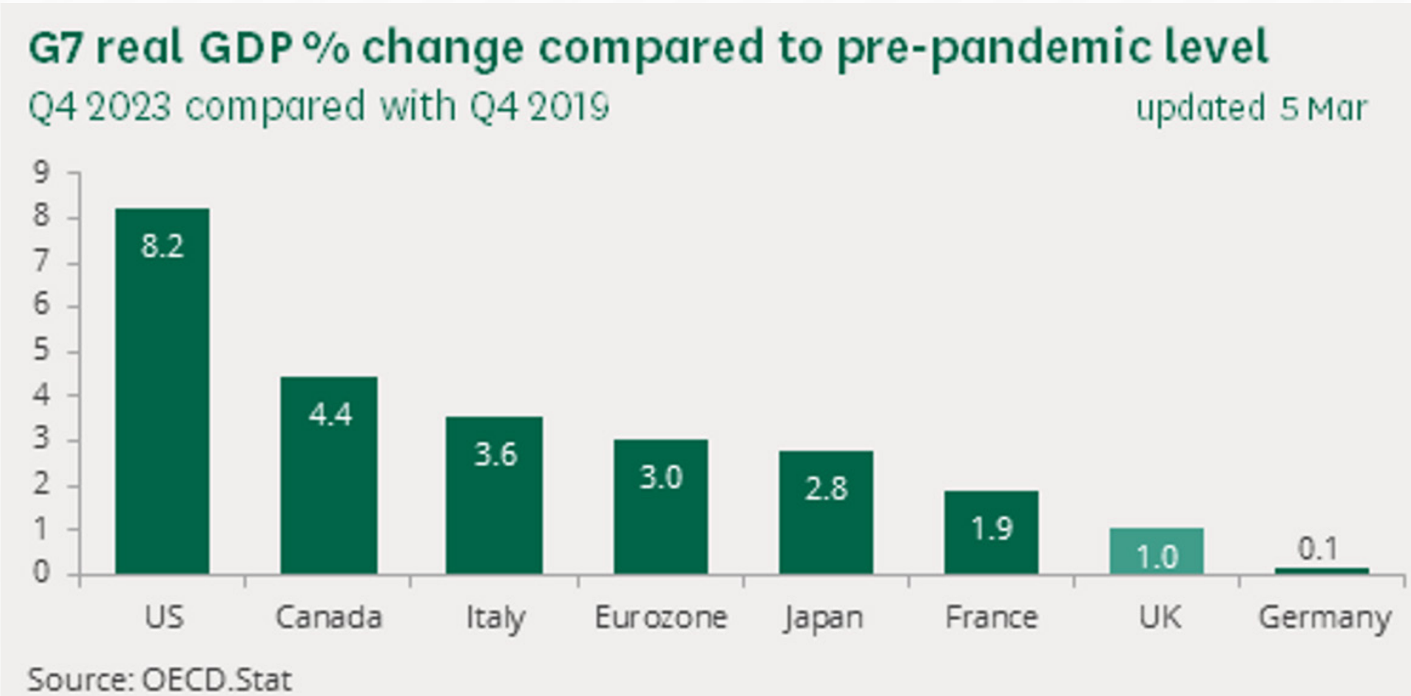
The British popular press has lost interest in the EU now the UK has taken back control. Austria, Germany, and the Netherlands GDP contracted slightly last year. The EU as a whole grew by 0.1% in 2023. Southern Europe outperformed the North. Their stock markets are doing well. As the chart shows, the UK is struggling compared to the EU as a whole.

Inflation is now 2.6%, wage growth 3.1% thus real incomes are improving. Real sales volumes have picked up slightly. The composite PMI is just under 50, whereas the UK is just under 53.

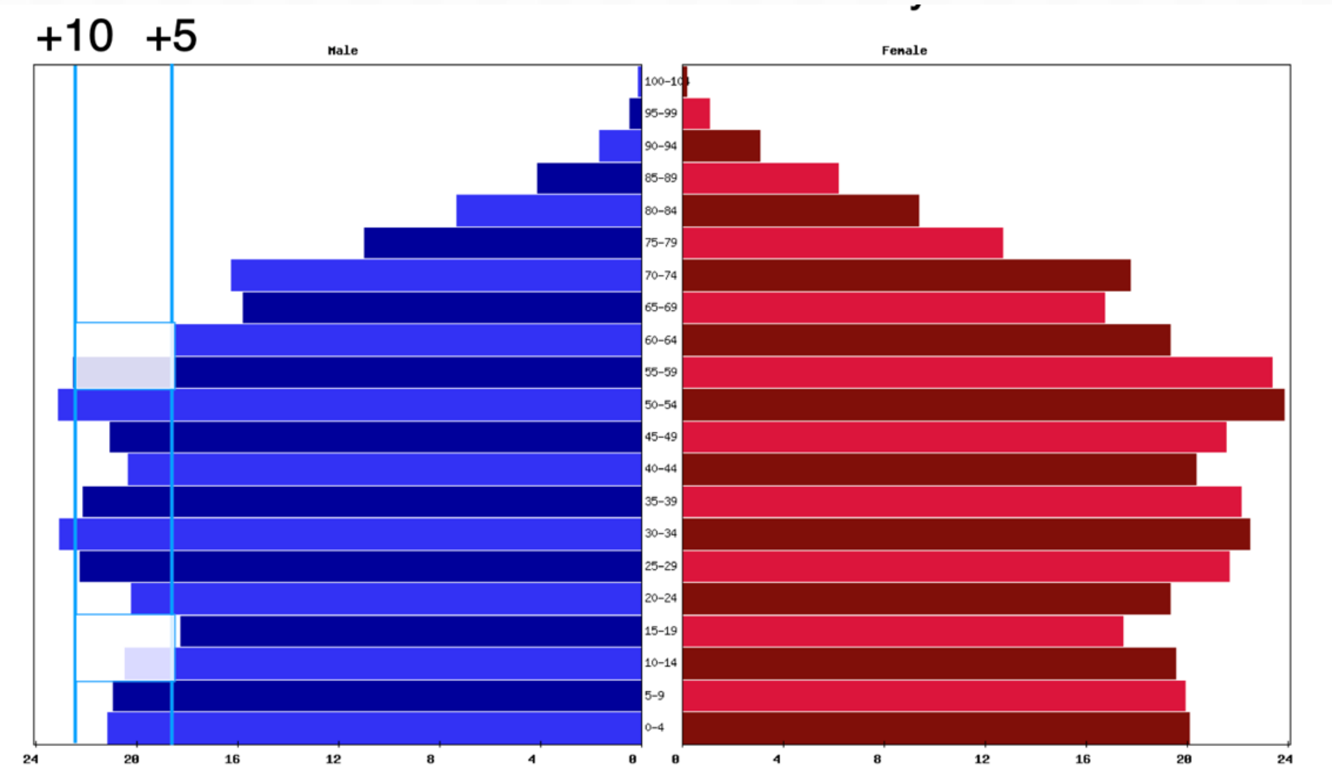
This data suggests there is a bit more optimism in the UK than the EU. As you can see from the chart on the next page our goods trade with EU has declined since we left. On both sides of the channel Brexit has made trade more cumbersome and expensive. As Jacob Rees-Moog emphatically stated on GB News recently "any country which reduces its trade will have lower growth"!

The UK


30
20
10
0
-10
2002
2005
2010
2015
2020
2023
Excluding precious metals
© FT


G7 real GDP % change compared to pre-pandemic level
Q4 2023 compared with Q4 2019
updated 5 Mar
8.2
4.4
3.6
3.0
2.8
1.9
1.0
0.1
US
Canada
Italy
Eurozone
Japan
France
UK
Germany
Source: OECD.Stat

The Labour Market is still tight and will remain so for the next ten years



The real price of the average house is the same as 2005, base rate then was 4.5%, 3% of mortgages were 100% LTV. 1.7m houses changed hands. Wages were growing at 3.5%, inflation 2.7%, real GDP growth 2.7%. Unemployment was 5%.

100% mortgages are available today, real incomes are growing at the same rate, interest rates will come down to 4.75% year end. Unemployment is 3.8%. The number of transactions is running at 87,000 a month (1.04m a year at this rate).

There is no financial reason why the housing market shouldn't rebound strongly this year.

There is no prospect of 2.7% real GDP growth, but 1.5% is achievable. If growth takes off inflation will rise again. I still think the inflation rate will be closer to 4% than 2% at year end.

I am sure the government will get what they deserve, which is time on the bench to work out what they stand for and who best to deliver it.

It's more than likely there will be a Labour government. Rachel Reeves knows she is inheriting a pup. There is no headroom for tax cuts or increases in government spend unless GDP grows by 6% nominal (and 2% real).
The good news is they have clearly stated that SMEs are the engine of UK growth. If they produce an apprenticeship scheme which is easy to operate, this would be a good start.

They are unlikely to put VAT at 20% on private schools. They might do 5% as a sop to the left wing. The top 20% of private schools would survive on 20%. But the bottom third would not. The public sector does not have sufficient places if these schools fail. Therefore, the tax 20% reduces educational opportunities.

They will get closer to the EU, it's madness not to.

Trade with the EU produces 15% of our GDP, trade with the USA 10%. We currently run a trade surplus with the USA of £29m, a deficit with the EU of £5bn. If Trump wins, our surplus with the USA is at risk.

Reeves has announced an 'industrial strategy'. Not big government and taxpayer funding but based on reform, private sector investment and stability. The success or failure will depend on the response of the private sector. When she called for "an approach that recognises the informational and capacity constraints of government, Reeves in her statements has confirmed to me that she has read the economist Friedrich Hayek, who warned of the impossibility of any central planner knowing enough to direct resources efficiently. It is not just about the Treasury not having the money for capital spending, but the government's inability to know exactly where scarce capital ought to go.

As a behaviouralist I remain convinced that if Labour prove they are bunch of grown-ups on a mission to enable the energy and creativity of the Brits to flourish, then our productivity, growth and reputation as a nation will improve.

John Maynard Keynes (a behaviourist) once wrote "anything we can do, we can afford". In theory a business-financed industrial strategy is possible. Government has many more tools than outright grants to induce investment: regulations, procurement policy, tax. Moreover, as the economist Professor Dame Diane Coyle has observed, successful examples have relied on "bottom-up" processes for generating ideas: listening, not just telling.

We will know in the first 100 days of a Labour government.

Conclusions

Real incomes both before and after tax are growing, having fallen for the past two years.

The Brits drew on their Covid savings to keep going. They were saving more than 30% of their income during lockdown. It's now 10%.

Investment spending is at last showing signs of recovery triggered by the 100% capital allowance now extended to leased assets.

The government is putting in a £100bn net stimulus.

The Purchasing Managers Index at 53 is consistent with stable growth.

If we have an election in June with a decisive result for Labour then I expect a strong performance in the second half of this year.

Final quarter GDP could be 3% above previous year.

The message for business owners is unchanged. Labour will be in short supply, its price will continue to rise. Look at every aspect of your business to see if you can substitute labour with technology.

Finally, a new government with energy and commitment will be the beginning of a revival in UK dynamism. SMEs will be the driver of growth as clearly stated by Rachel

Reeves.

www.vistage.co.uk

VISTAGE