

Novus Capital Markets Research

It takes two to tango

20 October 2011

What have the Europeans ever done for us? In his speech in Liverpool this week Mervyn King revealed quite how depressed and annoyed he is by the behaviour of our trading partners in Europe and Asia, in particular by the failure of governments in the euro area to get on top of the sovereign debt crisis and still under-capitalised European banks. We have done our bit by relaxing monetary policy to sustain demand in the face of a necessary fiscal adjustment but our strategy of rebalancing demand away from consumption towards investment and exports is threatened by a slowdown in the global economy. King points the finger at the surplus economies (Germany, Japan, China) which rely on export-led growth, competitive (and relatively fixed) exchange rates and which baulk at the fiscal expansion that is necessary for more balanced global growth even when their own economies are slowing sharply. As we found inside the ERM in 1990-92, when you get into bed with Germany you play by the German rules. Unlike the UK in 1992, which was able to withdraw from the ERM, for Greece it seems there is no way out. Growth in UK exports, which rose at a double-digit rate last year, has more than halved this year.

Inflation is deflation: September's 10% increase in gas & electricity prices took CPI inflation to a new high of 5.2% and intensified the squeeze on household budgets. Underlying (ex-bonuses) earnings are rising at less than 2% which translates into a 3½% cut in real terms. With the brief exception of 2009, when the temporary cut in VAT provided some relief, real wages have been falling steadily for the last three years. (You do not need to examine measures of consumer confidence to work out why spending is falling.) With further energy price hikes in the pipeline, we are still not at the peak in inflation though falling petrol price inflation will provide a useful offset. Ex-petrol, High Street inflation fell sharply last month, enabling volumes to turn in a decent (0.7%) increase. Even so sales overall fell 0.2% in Q3.

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It takes two to tango

1. We've done our bit

Reading the Governor's speech¹ to the Institute of Directors in Liverpool this week, I have the strong impression that he is deeply pissed off with our trading partners in Europe and Asia – and I presume the same would be true of his counterparts in the Treasury and Government. Our strategy of rebalancing demand towards exports is at risk because of recalcitrant trading partners who, even today and despite huge trade surpluses built up over the years, are still relying on export-led growth.

We, I guess he would argue, have done our bit. We have cut interest rates almost to zero (to unsustainably low levels) and set in train a second round of QE that will take the total of gilts purchased to £275bn, equivalent to nearly 20% of annual GDP. We have stabilised our banking system, taking RBS, Lloyds and Northern Rock into (full or partial) public ownership and finding a suitable home in the private sector for a number of smaller banks and building societies (Bradford & Bingley, Alliance & Leicester, Dunfermline etc). The Chancellor has embarked on a programme of fiscal consolidation designed to restore the underlying fiscal position to surplus within the timescale of the current Parliament. Encompassing all of this is a recognition that the debt-fuelled consumption model of the early 2000s has failed and that it is 'necessary and vital' to rebalance the economy away from (public and private) consumption towards investment and net exports.

2. What have the Europeans ever done for us?

Permeating the Governor's speech is the view that 'countries have responsibilities to each other' and that many of our trading partners in Europe and Asia are shirking (and have consistently over a lengthy period shirked) their responsibilities. The root of the problem is not just 'unsustainably high levels of consumption (whether public or private) in the United States, United Kingdom and a range of other advanced economies' but also its counterpart, the 'unsustainably low levels of consumption in China and other economies in Asia, and some advanced economies with persistent trade surpluses, such as Germany and Japan'.

¹ <http://www.bankofengland.co.uk/publications/speeches/2011/speech523.pdf>

The problem, he suggests, goes back a long way:

over the past two decades, some governments, particularly in Asia and the euro area, have tried to fix exchange rates without putting in place mechanisms to ensure that competitiveness could be rebalanced by other means;

and that this attitude has persisted even in the face of the global financial crisis:

from the very beginning of the global crisis there has been a reluctance by governments to face up to the underlying solvency problems generated by apparently unending trade deficits with no mechanism, whether flexible exchange rates or some other means, for correcting these disequilibria.

As evidence for this he observes that:

four years after the financial crisis began, the foreign exchange reserve holdings of China are substantially larger than at the onset of the crisis;

and warns that:

the burden of debt will go on rising in the former [deficit] group of countries until these spending patterns adjust and the latter [surplus] group will find their loans eventually repaid in depreciated currencies, if at all. Surplus countries, a group which includes three of the world's largest four economies, share a major responsibility to respond to our present dilemma by expanding domestic demand. By importing more they would provide deficit countries with the wherewithal to export and service debt repayments.

Ultimately the problem, he believes, can only be solved by a global rebalancing, though the reluctance of many economies to allow their exchange rate to move freely remains a considerable bar to this:

one way or another, domestic spending must be raised in the surplus countries and lowered in the deficit countries, relative to current trends.

In the meantime the absence of the necessary adjustment on the part of our principal trading partners is a huge problem for us:

we are trying to rebalance our economy at a time when a global slowdown, and concerns about the solvency of European banks and sovereigns, threaten recovery here in the United Kingdom ... A slowing of the world economy, especially in the euro area, is a threat to our strategy of rebalancing and recovery of the UK economy. Despite the more competitive level of sterling, the recovery in our trade position is at risk of stalling.

It is all very depressing, though hardly surprising, stuff. We learned the European lesson the hard way in 1990-92 in our brief period inside the ERM – if you get into bed with Germany, you play by the German rules. Then Germany's priority was to restrain demand in the aftermath of the unification boom. The hikes in interest rates that the Bundesbank deemed necessary proved impossible for us to match. The austerity programme that the Greeks are having to adopt is placing insuperable burdens on their economy in the absence of other adjustment mechanisms. Even this week, Germany is dragging its feet on accepting the measures that are necessary to get on top of the euro area's sovereign debt crisis.

It is hard to imagine that, if George Osborne had any leeway to relax fiscal policy, he would not take it. Yet economies like Germany and Japan see their economies stalling and take no action on the fiscal front. China for its part seems to resent the fact that its export growth dropped from 24.5% in August to only 17% last month. It is our duty apparently to purchase the output of Chinese factories.

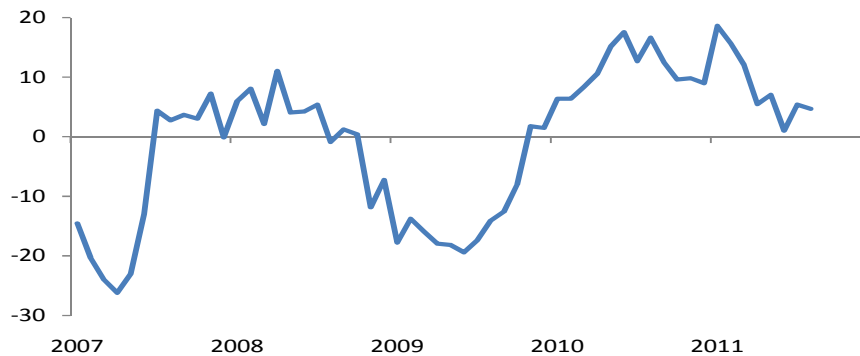
3. UK exports are slowing

I showed two weeks ago how the trade deficit in goods & services had shrunk from nearly 4% of GDP in real terms ahead of the financial crisis to under 1% of GDP in 11q1. It widened out again to 1.2% in Q2 as exports fell 1.3% against 0.3% for imports

Since then the August trade data point to a resumption of the downward trend. Underlying exports of goods (ex-oil & erratics) rose 1.3% in August a full 1pp more than imports. Exports of both oil and erratics were down in the month so that overall exports of goods were down 1.3% against only 0.1% for imports. Even so Jul-Aug combined showed a rise in exports of 2.1% from the Q2 average, ahead of imports which rose 1.7%. Depending on what happens in September and to services, the net trade deficit may have fallen back to around 1% of GDP in Q3, implying a contribution to growth of around 0.1pp – not a lot but better than nothing.

Even so there has been a very sharp slowdown in export growth. Last year, as the recovery got going, underlying exports were rising at a rate which averaged more than 10% for 2010 as a whole. By August this year the annual growth had slowed to 4.7% (Chart 1).

Chart 1: Exports (ex-oil & erratics, % y/y)



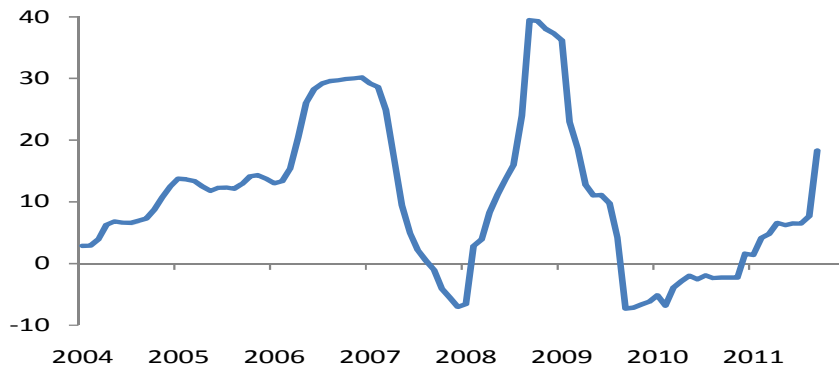
Source: ONS

Ironically, given the strictures of Mervyn King this week, exports to the EU were much stronger than exports to the rest of the world. In August alone underlying exports to the EU rose 6.3% while non-EU exports fell 4.2%. That may just be noise because the increase in Jul-Aug from Q2 was bigger for the non-EU (3.8%) than for the EU (3%).

Squeeze

On Monday Energy Secretary Chris Huhne hosted an energy summit with the big six utility companies. On Tuesday we learned why. With three of the six major suppliers having raised their prices in the last month or two (and the rest due to follow in the coming months), gas & electricity price inflation leaped from 7.7% in August to 18.3% in September as prices rose 9.9% in the month. This is the third major bout of gas & electricity price inflation in the last five years: prices have doubled since the start of 2005 (Chart 2).

Chart 2: Gas & electricity price inflation (% y/y)



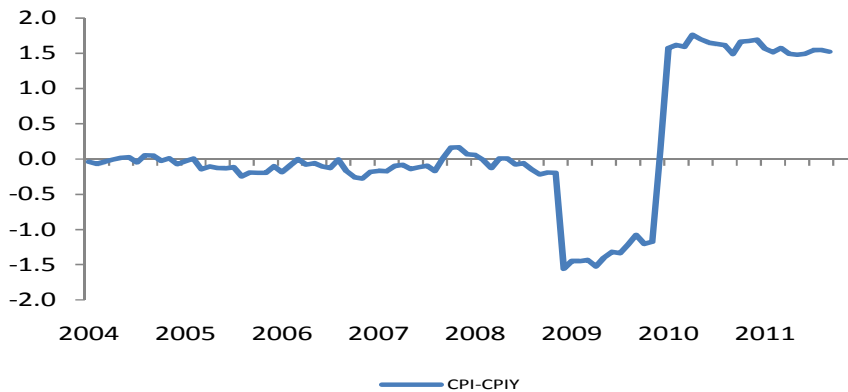
Source: ONS

CPI inflation rose from 4.5% to 5.2% (which is good news for USS pensioners) with 0.4pp of the 0.7pp increase coming from gas & electricity. There were further upward contributions from petrol (fuels & lubricants) where the annual rate rose from 17% to 17.8% and from food (5.6% to 6%). Overall non-core (food, alcohol, tobacco and fuel) inflation rose to 11.1% from 9% in August; a year ago it was only 4.3%. Core inflation rose from 3.1% to 3.3% with the biggest contribution coming from seasonal transport (air and sea fares, where fuel costs are a major consideration), which fell less this year than a year ago. The only significant downward contribution came from clothing & footwear but only because this year's price rise (4.4%) was a little less than last year's massive 6.4%.

With NPower having raised its prices this month and EdF due to follow in November, inflation has still not peaked. But there may not be much more to go since petrol price inflation is falling quite sharply. On the latest weekly data prices were down in the first two weeks of October and flat in the third where in October last year they were rising by more than 0.5% a week. As a result by the third week in October the annual rate had fallen by some 3pp from the September peak. Providing prices do not start going up again the downward trend should continue through to the end of the year (petrol prices rose 4½% in Nov-Dec 2010) and into 2012. On top of falling petrol price inflation a new price war seems to have broken out between the supermarkets which should lower food and other goods inflation in the coming months.

Once we get into 2012 and the January 2011 VAT hike drops out of the annual rate, inflation will fall more sharply as the headline rate will converge back onto the underlying rate. CPIY inflation, which excludes indirect taxes, is currently running at 3.7%, 1.5pp below the headline rate. It was above the headline rate in 2009 following the temporary cut in VAT to 15% and has been below it for the last two years with VAT being restored to 17½% and then raised to 20% (Chart 3). If at that stage underlying inflation is also falling quite sharply, the headline rate should be on track for the 2% target by early 2013.

Chart 3: CPI inflation minus CPIY inflation

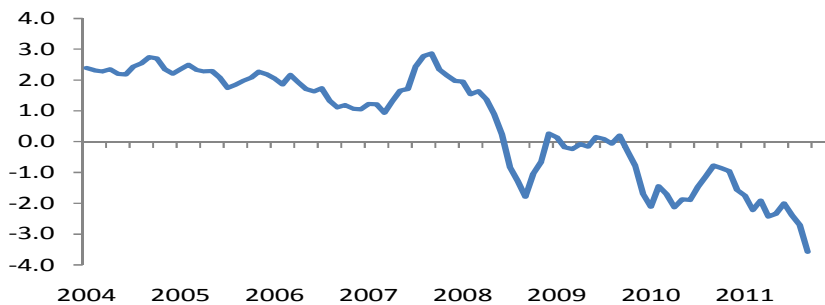


Source: ONS

Following the release of the CPI data there has been a lot of comment on the misery index which adds together the inflation and unemployment rates and which is at a near-20 year high. That is a good shorthand device for getting a handle on consumer sentiment (though direct measures of consumer confidence do the same job). Either way it is possible to tell a story that goes from the misery index or measures of consumer confidence to what is happening to consumer spending. It is even possible to estimate models that relate the quarterly path of spending to measures of consumer confidence – though, personally, I don't see the point when you can tell a far more convincing story via real earnings (or is it somehow the case that consumer confidence/sentiment is unrelated to what is happening to real incomes?).

The latest earnings data show headline earnings up 2.2% in the last year (2.7% 3m y/y) with the ex-bonuses rate up only 1.6% (1.8% 3m y/y). If we use the ex-bonuses measure as a guide to what is happening to underlying earnings and assume that its growth slowed to 1.6% 3m y/y in September, then real earnings have fallen 3.6% in the last year. This is a huge squeeze, much larger than at the previous inflation peak (September 2008) when underlying earnings were still rising at a comparatively healthy 3.4%. With a brief interlude in 2009, when the temporary cut in VAT lowered inflation, underlying earnings have been falling steadily for the last three years (Chart 4). You don't need separate measures of consumer confidence to deduce that falling real earnings are not good for consumer spending.

Chart 4: Real earnings (ex-bonuses earnings 3m y/y minus CPI inflation)



Source: ONS, Novus

With earnings growth close to 2% it is surprising that the cash spend on the High Street is still running at a rate of 5.3% (3.7% ex-petrol). It is less surprising that in the face of high inflation sales volumes are struggling. September seems to have gone against the trend with a rise of 0.6% (0.7% ex-petrol) though Q3 was still down on Q2 (-0.2% on both measures). What was more encouraging was that underlying (ex-petrol) inflation on the High Street fell sharply in September to 3.3% from 3.9% in August.

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