Only three months ago, I gave evidence that we were close to the top of the cycle. I am now worried that the current combination of global events could create a perfect storm. Brexit is a side show but it increases the risk for the UK economy.

Donald Trump apparently has a degree in Economics, but this could be a fake Wikipedia entry! He should have learned three things.

- Firstly, an economy is characterised by strongly positive feedback: a small change in one part of the system is magnified as other parts of the system react. Positive feedback is the mechanism which magnifies small changes to create boom and bust;
- Secondly, the so called Prisoners' Dilemma: a theory which shows why two completely rational individuals might not cooperate, even if it appears that it is in their best interests to do so. In trade, it always pays to cooperate; no one wins a trade war;
- Thirdly, the role of the Federal Reserve is to ensure that inflationary expectations do not take off by raising interest rates in a timely fashion.

As I write this, there are a number of activities in the Global system which, in the next twelve months, could combine to create a perfect storm. A perfect storm is an event in which a rare combination of circumstances drastically aggravates the event.

Here are the circumstances:

- Due to USA sanctions on Iran (and a faster than expected global growth rate), over the last year, the oil price has doubled.
- US tax cuts are causing the US economy to overheat: registered unemployed is now 3.9% (the same as the UK).
- The US inflation rate is now 2.9%. The most recent real growth rate is 4.1%. This is well above the long run average growth rate of 3.2%.The response of the Federal Reserve will be to continue raising interest rates. Historically a 1% increase in the Fed funds rate reduces real GDP growth by 0.7%. However given the scale of the fiscal stimulus (an extra $1.2 trillion dollars over the next five years), the impact of interest rates on growth may be lower. The implication is that interest rates will have to be raised by more than expected.
- A 1% increase in US rates lowers emerging market (EM) economies' growth by 0.8%. Ems include Brazil, Chile, China ,Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Qatar, Peru, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand, Turkey and United Arab Emirates.

Source: *Lacoviello, Matteo and Gaston Navarro (2018). Foreign Effects of Higher U.S. Interest Rates. International Finance Discussion.*

EM countries typically run a current account deficit thus relying on foreign capital inflows to fund those deficits. In order to attract that foreign capital inflow, they offer high interest rates. When U.S. interest rates were low, the so-called 'carry trade' (the practice of investors borrowing cheap US money and investing it in these higher-yielding currencies) supported the EM world.

Last year, the weak dollar also helped those EM economies. But as the interest rate differential between the dollar and emerging market currencies narrows, the latter become less attractive, discouraging investors from taking on the investment risk. Increasing currency volatilities in emerging markets is sending capital back into the dollar.

This poses a threat to the EM countries. Their economies grow by leveraging, but not only is that foreign money not coming in, their foreign borrowing levels - primarily denominated in U.S. dollars - are surging as a result of the stronger dollar and higher US interest rates.

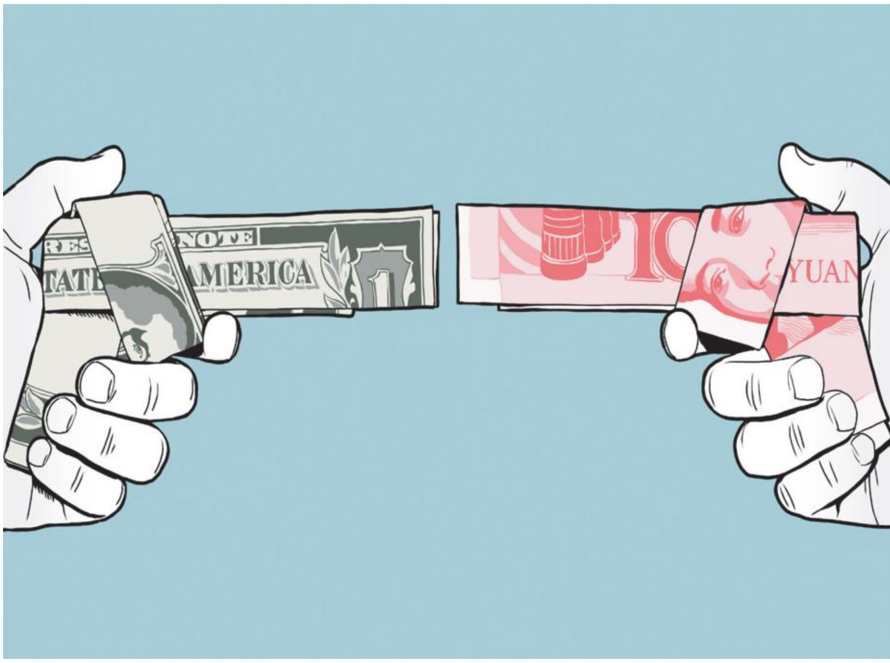
To illustrate this phenomenon, since the beginning of this year, the Turkish Lira has fallen by 20% and the Brazilian Real by 11%. The South African Rand and Russian Ruble seem equally vulnerable.

Although not an emerging market economy, the UK has to attract around £80Bn of foreign capital each year to finance its current account deficit. If the Bank of England fails to raise UK interest rates, we will see a weaker pound, especially against the dollar.

The Threat of Trade Wars

We are beginning to understand Trump's approach: he threatens and then climbs down. However the threats have a material impact: they cause uncertainty and encourage corporates to conserve cash. China has just announced a reduction in required reserve ratios for banks and a fiscal stimulus to offset the slowdown which began following Trump's tariff announcements.

Last week we saw Juncker on the steps of the White House apparently having influenced Trump not to impose tariffs on EU produced cars. It is probable that the EU threat of tariffs on $400Bn of US exports had an impact! But meanwhile M-B and BMW issue profits warnings and their shares lose 10% of their value. And the key German IFO index which surveys 7,000 businesses across all sectors shows a significant softening of confidence.



Brexit

It is unclear if the EU will agree to the UK's proposed withdrawal conditions. The UK has created a brilliant fudge which the EU can see through. The European Parliament threatened to veto any agreement if the UK did not do more prevent a hard border with Ireland after it leaves the bloc. And to date they do not accept that a third country (the UK) should be allowed to collect tariffs on goods imported to the UK and then exported to the EU. Both parties are preparing for a no deal situation. And as at July 30th this looks the most likely outcome.

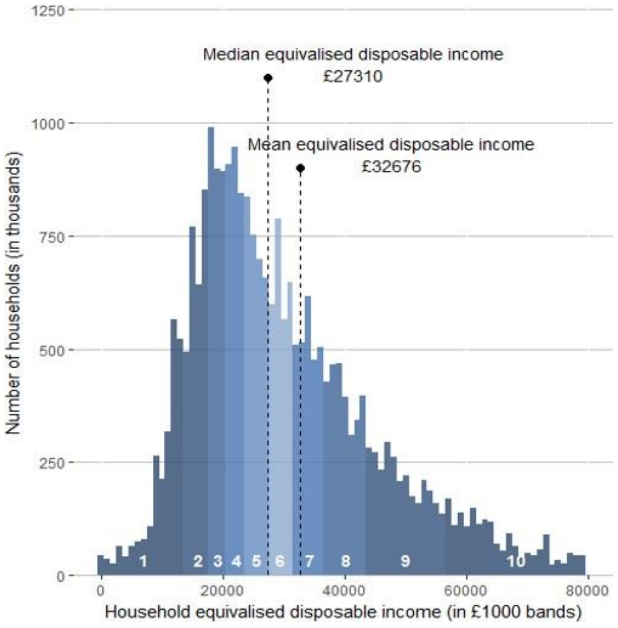
The expectation of a no deal has more impact than the event itself (if it happens). The latest survey of CFOs in the UK shows they are taking a much more cautious approach to the future. In particular, they are increasing their cash balances. It has to be stated yet again: when corporates run for cash, SME's suffer. In addition, UK banks are tightening their lending criteria. The impact is a reduction in the velocity of money, lower than expected sales, and a slow down, or at worst a recession.

Since the Nation voted leave 18 months ago, exports to a booming global economy offset the sluggish growth in domestic demand. Thanks to Mr Trump, the global economy is slowing and the offset for UK growth is weakened. Real pay is only just growing.

If we look at the distribution of disposable income, we can see most UK households live on less than £30,000 a year, after tax. Since the vote to leave there has been no improvement in real incomes for the majority.

Average weekly earning total and regular real pay annual growth rates whole economy, seasonally adjusted

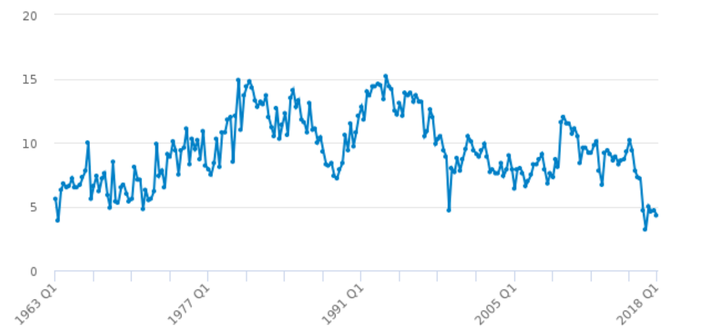
Germany IFO Business Climate Index



Households have reduced their savings rate and increased their debt to maintain consumption. In 2017, they spent £25Bn more than they earned (that averages out at £900 per household).The poorest 10% of households spent two and a half times their disposable income, on average, in the financial year ending 2017. The richest 10% spent less than half of their available income during the same period. The ONS found that the deficit among UK households, equivalent to 1.2% of GDP, contrasted with a surplus in France equivalent to 2.7% of GDP and a surplus equivalent to 5.1% in Germany. The ONS said households took out nearly £80bn in loans in 2017; the most in a decade. But they deposited just £37bn with UK banks. Banks must be balancing their book by accepting business deposits and/or borrowing short term in the wholesale market. You will recall the crash in Q3 2008: the wholesale market ran out of money due to a lack of trust in the London market. Could a no deal Brexit do the same again?

This all points to an economy which is vulnerable to small and unplanned events and households which have little in the way of cash reserves if there are layoffs or fewer hours of work required.

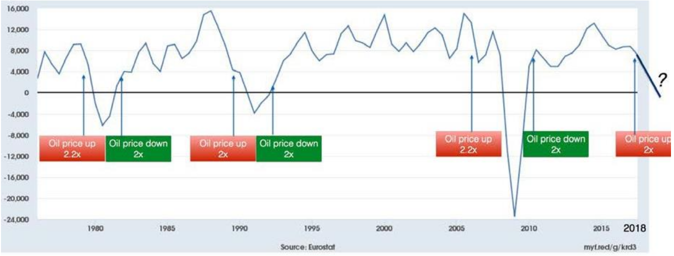
HH & NPISH Households' & NPISH saving ratio (per cent): Current price £m: SA



NPISH is non-profit institutions serving households

The Price of Oil

The graph below shows than when the price of doubles, a recession almost inevitably follows within 18 months. The exception was 2005. A doubling in the price of oil sucks spending power out of oil importing countries, it ends up with oil exporting countries who do not spend it immediately: the global velocity of money drops sharply. In 2005 oil went up 2.2X but households maintained their spending using credit.
This time around they are mostly maxed out and banks have already tightened their credit terms. Hence the possibility of a recession a year from now.



In Summary

A boom in the USA requires significantly higher interest rates. The USA sets the level for the World. Emerging markets face much higher interest rates or a collapsing currency. The doubling in the price of oil squeezes household discretionary income. UK households are particularly vulnerable. Fearful finance directors conserve cash so smaller companies are not paid on time. Existing money works less hard and new money does not expand sufficiently to offset this. The result is an unplanned drop in sales in all sectors, except those supplying the oil and gas industry. A sharp slowdown, possibly followed by a recession. For the UK, the Brexit uncertainty increases the chance of a recession in the next 18 months.

As the Western World heads for the beach and the mountains we can hope for some respite. When people return to their desks in September, refreshed, and able to think more strategically, I hope the threats of a hard Brexit and Trump trade wars diminish and that yet again, I will be proved wrong!

Have a restful summer.
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Roger is a graduate of the University of Leicester. He has worked in the New Zealand Treasury, at the Bank of England and, for many years, was Client Director at Henley Management College where he worked with a wide range of businesses. He is a behavioural economist who believes that economic forecasting is an art, not a science and that it is crucial to estimate the nature, size and impact of 'animal spirits' when looking forwards. He believes that Government cannot control the economy; it can only influence the behaviour of economic agents. He was one of the few who forecast the depth of the recent recession based on his anticipation of the behaviour of the banking system. He thinks it is better to be broadly right than precisely wrong when forecasting the future!