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WHY WON'T YOU DO AS YOU ARE TOLD?

Strategy and economics

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First it was the stock market; now it is household spending: financial and economic trends are defiantly failing to develop as predicted. That the international nature of the FTSE 100 has boosted the index to its highest levels since mid-2015 is, perhaps, a little easier to understand, given the post-Brexit-referendum fall in the value of the pound. However, it is harder to explain away the strength of the FTSE 250 Index (which is approaching its all-time high) and also that of the FTSE Small Cap (ex Investment Trusts) Index – which is at an all-time high.

Clearly, a few of us have not read the script; either that or investors are making a horrible mistake. A vote for Brexit was, we were warned, akin to a vote for recession. But this is not what the stock market indices are telling us.

Meanwhile, activity on the high street has not collapsed, seemingly discrediting the dire assessments of the implications of a post-referendum slump in consumer confidence. In one of the earlier pieces of evidence, the CBI reported that sales volumes in July had slumped, falling more than at any time since early-2012. But the ONS has subsequently published data showing a sharp month-on-month rise in retail sales volumes in July, resulting in year-on-year growth in retail sales of 5.9% – the highest rate since an upwards blip in September last year.
If nothing else, this highlights the risk of trusting more sentiment-driven 'evidence' from surveys of economic attitudes and behaviour. More contemporaneous evidence comes from the weekly John Lewis sales numbers for August, which continue to look reassuring.

Of course, financial markets can quickly reverse, and it is more than possible that bullish sentiment will be replaced by more bearish thinking later in the year. It is also true that the stock market is reacting to other financial developments – more of which later. Equally, I would not suggest that we should make our assessment of the impact of Brexit on the basis of one economic indicator.

However, I detect a subtle change of mood in the UK. Yes, people are concerned about a protracted period of uncertainty and a potentially negative Brexit settlement. On the other hand, I think there is also a growing belief that the UK economy will not be struck down by these known unknowns and could actually be invigorated by the challenges it faces.

As yet, the evidence that we have from industry is scant. I would caution against placing too much weight on survey evidence showing that activity in services and manufacturing has slumped. As with household spending, it is better to await hard data. In this context, it is worth examining one early piece of statistical news from the labour market. It is far too early for companies to have made significant moves in terms of employment – so it is too early, also, to expect to see any impact of the referendum result on unemployment (although, if you are interested, the claimant count measure of unemployment unexpectedly fell in July by 8,600 to 763,600). But, the first way in which employers can react to a perceived change in economic circumstances is to change their hiring intentions. Job vacancies data have been published in July, and show a slight dip in the three months to July compared to the three months to June. This continues a marginally weakening trend since a high in January. Even so, job vacancies remain higher than a year ago and way above the levels recorded at the peak of the last business cycle. I think this will be a key indicator to watch in the future when we are informing ourselves about real Brexit effects.

This leads me on to the Bank of England's (BoE) latest pronouncements: the decisions by the Monetary Policy Committee (MPC) to cut Bank Rate 0.25% to 0.25% and to restart the policy of quantitative easing (QE). It was claimed by the BoE's chief economist that this action was to try to prevent "hundreds of thousands of people losing their jobs". I would suggest the opposite – that the BoE risks intensifying the negative consequences of the Brexit vote by sending wholly unjustified negative signals to households and businesses. To date, there has been no real evidence to warrant such policy moves (and little more than was available at the Bank's previous meeting).
More to the point, even if the BoE were correct in believing in the significantly deleterious impact of the referendum vote, does it really think that a cut in rates from 0.5% to 0.25% and £70 billion of additional QE will make a significant difference? Sure, one of the effects of these measures has been to drive down gilt yields (another reason, perhaps, for some of the strength in the equity market), but this is simply accentuating the prevailing mispricing seen in government bond markets. It certainly is not helpful to the many companies who will have to wrestle with even greater problems of underfunding of company pension schemes – something that could leave less cash for capital spending.

So why did the BoE feel it necessary to make its August moves? My view is that the immediate transparency of the policy-setting process interferes with the MPC's independence of thought, making it more prone to take populist policy decisions. But there is a trap for the MPC in thinking that it has always to be seen to be doing something, in that it exposes policy to becoming driven by mood rather than cool economic assessment. Certainly, the committee failed to articulate how it expects its recent policy changes to feed through to the real economy.

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