Lombard Street Research Ltd.

Economic Analysis for the Institutional Investor

33 Lombard Street, London EC3V 9BQ Tel: 071-623 9981 Tlx: 883589 Fax: 071-623 6173

Investment themes 3.

Key points

- The Gulf crisis doesn't really matter very much

Despite the heavy falls in bond and share prices, this is stating the obvious. In the event of a prolonged embargo, the cost to the USA of the Gulf military presence is at most 0.1% of GDP, the interruption of oil supplies will be minor because of increased Saudi production and Iraq-Kuwait barely matters otherwise to the world economy. In the event of hostilities, Iraq will lose. The slump in bond prices since the crisis erupted is a buying opportunity.

- Strange GDP figures ahead

The Q2 industrial production figures were strong not only because of high June oil output, but also because of an official estimate of a sharp rise in engineering production. The bouyancy in engineering conflicts with survey evidence and is barely credible. For the record we should note, nevertheless, that

i. it casts doubt on our forecast of GDP growth this year of under 1/2%, and

ii. it means that a "recession" (if partly due to correction from an aberrantly high Q2 figure) is inevitable in the second half of 1990/early 1991.

- Cash no longer attractive relative to UK equities

One of our themes this year has been that (starting from FTSE levels above 2,300) it would be difficult to beat cash with its safe yield of 14% - 15% and that institutions should keep above-average cash proportions. However, after the recent fall the balance of advantage has moved away from cash.

At some point in the next year the dividend yield on the FT all-share ought to return to 4 1/2% or so compared to the present 5 1/4%, giving a capital gain of over 15%. With the 5 1/4% yield and capital gains from dividend growth (presumably in the 5% - 10%) area, the total return from UK equities would be 25% - 30%. Cash should therefore be committed to the market.

Professor Tim Congdon **20th August, 1990**

A subsidiary of Gerrard & National Holdings PLC

Directors: Professor T.G. Congdon, R.J. Elkington, Professor C.A.E. Goodhart
Registered office: 32 Lombard Street, London EC3V 9BE Registered in England No. 2357712

Investment Themes, August 1990

How much does the Gulf crisis matter?

Financial markets are in a tizzy over the Gulf crisis. They appear not to be asking the obvious question of how much it really matters. Two outcomes (or types of outcome, because there are variants) need to be considered:

1. Early hostilities in the Gulf.

One does need to be a great military strategist to know that nowadays warfare is all about electronics, technology and missiles. For obvious reasons leading industrial countries do not sell their most sophisticated weapons to Third World countries. Any fighting between Western/Arab and Iraqi forces will therefore be very one-sided. (It should be more straightforward than the Falklands War in 1982. The use of chemical weapons might be gruesome, but - since they have many more infantry than the Western forces - the Iraqi forces are much the more vulnerable on this count.) Because the US and its allies have command of the sea and air, the flow of oil out of Saudi Arabia and the United Arab Emirates should be uninterrupted even in the event of fighting. *It is worth emphasizing that Iran continued to supply oil to world markets throughout the Gulf War.*

2. Prolonged embargo, with Iraq-Kuwait effectively cordoned off from the rest of the world.

The two main costs would then be as follows:

i. ***Extra costs of military operation in the Gulf.*** The *Financial Times* (16th August) suggested that the extra cost of the Gulf operation for the US defence budget was $10m. - $15m. a day or $3 1/2b. - $5 1/4b. a year. US GNP is about $5,000b. In other words, the cost to the USA of maintaining the embargo and blockade is equivalent to at most 0.1% of GNP.

ii. ***Interruption of world oil supplies.*** In 1989 Iraq-Kuwait together produced about 4.4m. barrels a day and accounted for 7.1% of world oil production, 9.4% of "free world" supplies (i.e., OECD and LDCs) and 19.3% of OPEC production. Total world trade in crude oil was 22.2m. b/d. The shortfall from Iraq/Kuwait cannot be made good immediately, but the indications are that Saudi Arabia will increase production fairly quickly by 1 1/2m. - 2m. b/d, Venezuela by 1/2m. b/d and the UAE by 1/2m. b/d. Oil imports are between 1% and 2% of most industrial countries' GDPs. It follows that the Gulf crisis has halted a flow of oil equivalent to 0.1% or 0.2% of industrial countries' GDPs. (Of course, in the UK's case there is hardly any net effect.)

The impact on their balances of payments is appreciably greater, because the oil price has risen and the higher prices apply to all oil imports. As is well-known, at a price of $25 a barrel, the cost of extra oil imports is 3/4% - 1% of GDP, varying from country to country. However, over time the rest of OPEC may make good the shortfall more completely - and the impact on the West would be very small.

Do either of these outcomes justify a rise in bond yields around the world of over 1/2% and a fall in equity values of over 10%? Should the value of all the assets and profit streams represented

by the equity quoted on Western stock markets really be cut by over 10% because of recent events in the Gulf?

There may have been other reasons for the recent slide in some bond and equity markets. But the Gulf crisis by itself is surely not sufficient to explain price movements. The underlying, ex-Gulf news background for some asset categories - notably for US bonds - has in fact improved strongly in the last fortnight.

As in May, US Treasury bond yields of 9% (which they have never exceeded by much since 1985) are extremely attractive and US Treasury bonds are a strong buy.

Strange GDP figures

CSO data (released last Tuesday) on industrial production was surprisingly strong. Industrial production rose by 2.4% in the second quarter of 1990. Since the output of the production industries constitutes 34.4% of GDP, this influence by itself will add 0.8% to GDP. If there was some growth in services output, agriculture and so on as well, the quarterly rise in GDP could be 1% - 1 1/4% (i.e., at an annual rate of 4% - 5%).

If this guesstimate is right, the GDP figures (due out tomorrow, Wednesday) will receive considerable attention in the media. They will indicate the highest quarterly growth since 1988, contradicting our argument that the slowdown threatens to become a recession. Moreover, it would appear to invalidate our forecast that GDP growth this year will be minimal, in the 0% - 1/2% range. In fact, GDP growth (on this output-based measure) could be as low as 0% only if GDP fell by 3% in both the third and fourth quarters, which is unlikely. On the face of it, the second-quarter industrial production and (probably) GDP figures are difficult to reconcile with our view on the economy. However, a number of points are in order.

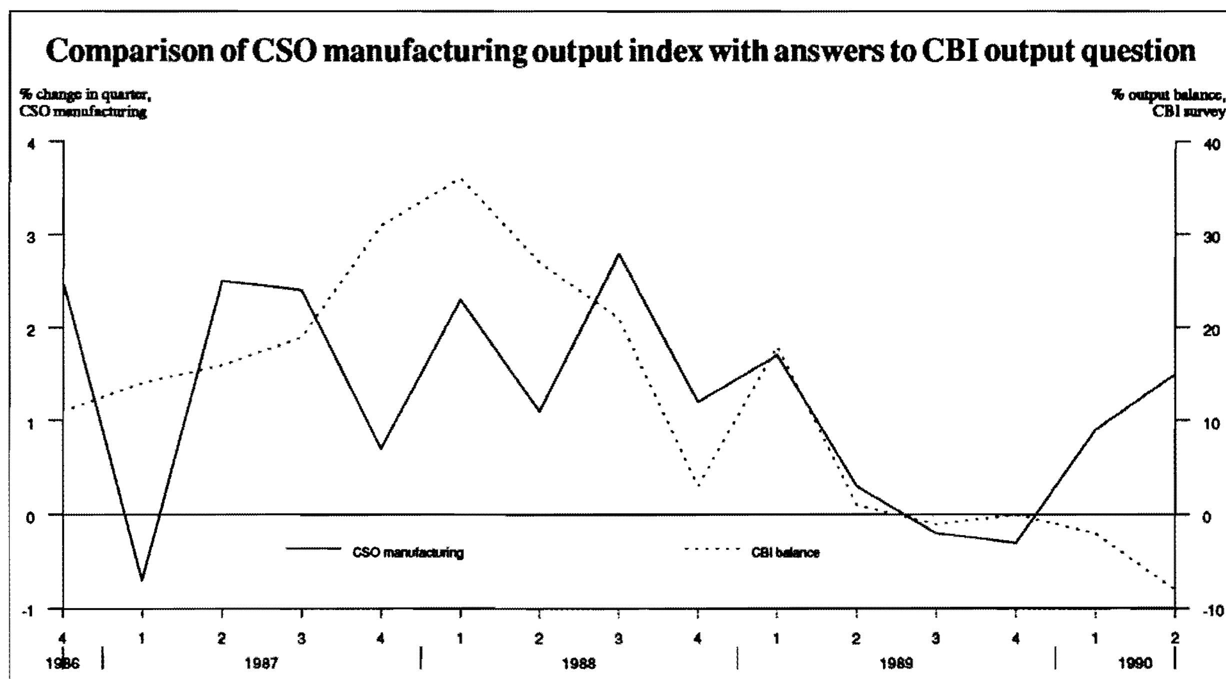
1. High Q2 growth due to surges in production of oil and engineering goods.

The recorded jump in industrial production was driven by a 3.1% advance in engineering output (which accounts for 20.3% of total industrial production) and a 5.2% rise in energy production (30.1% of total). Both should be seen as freakish.

First, the official data on engineering production are barely credible. They suggest that the engineering industries, the heartland of British industry, increased output at a faster rate in the second quarter than at any time since 1985, including 1988 (undoubtedly the peak of the recent cycle)! This is wholly at variance with survey evidence from the Confederation of British Industry. In the chart below we contrast the official industrial production series (quarterly change) with the balance of respondents to the CBI survey on the backward-looking output question.

The answers to the CBI output question agree with other statistical evidence, giving the strongest levels of economic activity between Q3 1987 and Q4 1988, and showing a progressive (and continuing) slide subsequently. Our conclusion is that the official estimates for engineering output in Q2 1990 are haywire. The explanation may be that they are heavily reliant on figures for deliveries, as opposed to production. Heavy deliveries of aircraft (following strikes in Q1) and North Sea equipment (seasonally high in Q2, when there is a boom in North Sea development anyway) may have been responsible.

Comparison of CSO manufacturing output index with answers to CBI output question



Secondly, the figures for energy production partly reflect the timing of the North Sea maintenance programme. (The programme requires shutdowns, in order that equipment can be inspected, repaired and so on.) In June the maintenance programme was less than usual for the time of year and oil output was therefore much higher.

2. Output falls more likely in Q3 and Q4.

The Q2 industrial production figures may have been an upset for our forecast of the economy. But, ironically, they make it more likely that the economy will have a recession. (A recession means, in this context, two or more quarters of falling output, in line with American usage.)

Unless all the survey evidence now pointing to recession is suddenly turned upside-down, it will be very obvious two years from now that Q2 1990 was an odd mini-peak. Output, as measured by the official statisticians, will almost certainly slump in Q3 and still be lower in Q4 than in Q2. So the economy will have had its "recession", even if it was partly attributable to the quirky buoyancy of the Q2 number.

An output fall in the second half of the year can be forecast with some confidence because of

i. ***A drop in North Sea oil production,*** as the maintenance programme gets under way. The Royal Bank of Scotland has forecast that oil output will be 10% lower in the second half of 1990 than the first.

ii. ***Falling output in the construction sector,*** reflecting survey evidence and available data on orders.

iii. ***The latest CBI survey,*** indicating that there are now ***more companies planning to cut output than to raise it.***

3. GDP is estimated on output, expenditure and income bases.

The Central Statistical Office compiles GDP numbers on three distinct bases - output (how much is produced), expenditure (how much is spent) and income (how much is received in wages, salaries, etc.). In principle, they should be the same. In practice, they often diverge widely. It will be interesting to see if the other GDP measures are consistent with the output- based number. (GDP on the other two bases is published some weeks later than GDP on the output basis.)

Our conclusion is that - while our forecast of nil or very low growth this year is now unlikely to be correct - our analysis of the economy is likely to be vindicated by a sharp fall in output in the second half of 1990. We hold by our view that, without large interest rate cuts, the slowdown will become a recession. In fact, because of the eccentricities of the Q2 figures, a "recession" (in the official statistics) is now surely inevitable.