fathom
Independent Thinking

Round-up: from global interest rates to public sector bankruptcies

31 August 2021

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This month Fathom's focus has ranged widely, from the long-term impact of China's investment policies in dragging down global interest rates and bond yields, to the turbulent effect of COVID-19 on UK labour markets and local government finance.

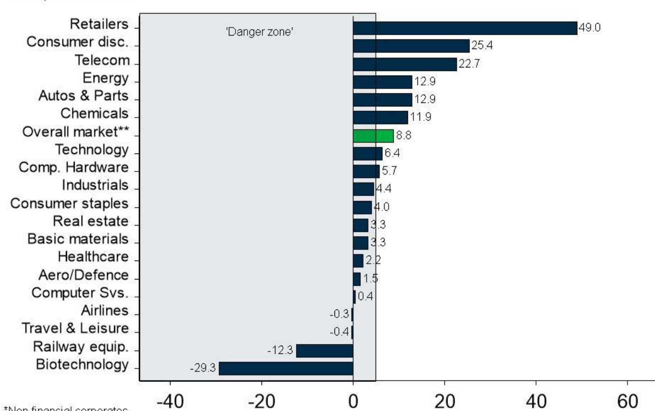
The charts in this new strand of *In Brief* research notes are not intended to be our final, considered view, but are punchy contributions to the ongoing in-house discussion that culminates in our quarterly *Global Economic and Markets Outlook*. We hope you will find them as stimulating as we do.

China's struggling strategic sectors

- Chinese macro data generally need to be taken with a bucket rather than a pinch of salt, though the financial data of private companies are less likely to be distorted
- Measures of corporate health (in this case, the interest coverage ratio) show that many companies in sectors deemed by the Chinese authorities to be strategically important, such as aerospace and biotechnology, are struggling
- It is possible that their poor financial performance is partly facilitated by implicit (moral hazard) or explicit (subsidies) backing from central government
- While an ability to wear losses is an advantage when trying to break through in new industries, it does not guarantee success. Indeed, Fathom measures show that China's global market share in key advanced technology exports has stalled in recent years

China NFCs* interest coverage (solvency)**

Rate, 30/06/2021



*Non-financial corporates
**Estimation on cash flow basis: free cash flow / interest expense
***Excluding financial firms

Source: Refinitiv Datastream / Fathom Consulting

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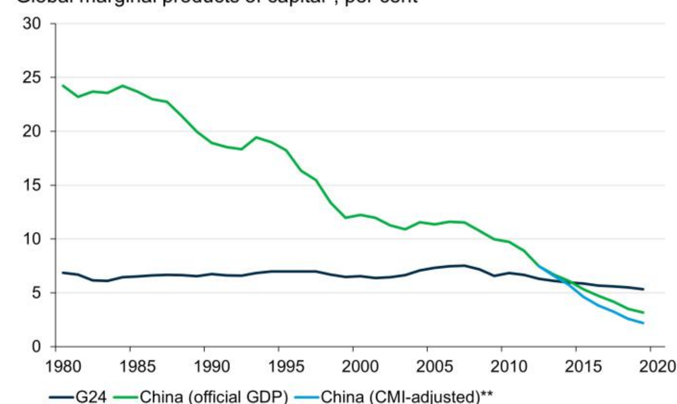
The China effect and US government bond yields?

- Fathom's proprietary Global Economic and Strategic Allocation Model (GESAM), points to a 2.2 percentage point decline in the global marginal product of capital (MPK) since the Global Financial Crisis
- Trends in the global MPK should be closely matched by trends in the global real cost of capital, and Fathom's model output closely matches the drop in long-term US bond yields over the same period
- One factor behind the secular decline in interest rates globally is China, where the marginal product of capital has been in secular decline for decades



- As China continues to 'over-invest' and its share of global GDP continues to rise, we expect its MPK to head further south, weighing on global yields
- Despite a global inflationary outlook, the China effect could be one reason why investors continue to believe that the 'new normal' of low interest rates is unlikely to end any time soon
- Indeed, it may help to explain the large gap between US inflation and long-term US government bond yields

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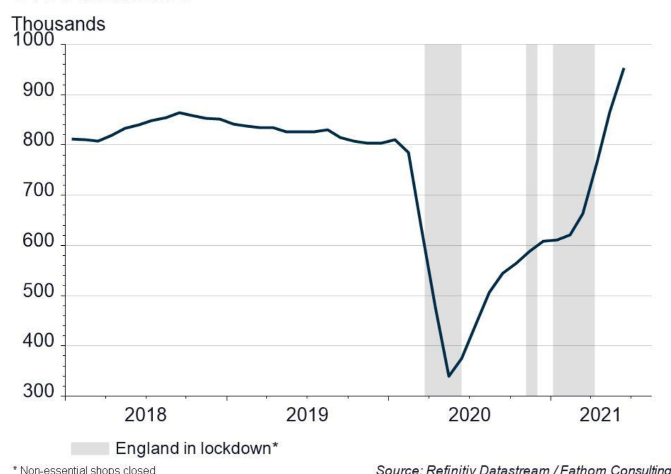
UK labour market data highlight labour market frictions

- UK vacancies rose to an all-time high of 953,000 in the three-month period between May and July, although there were 2.3 million unemployed over that same period as well as 1.9 million people on furlough at the end of June



- High vacancy rates against a backdrop of high furlough rates point to labour market friction
- There are several possible reasons for this friction. Varied demand for firms means that there could be some companies hiring while others in the same sector continue to keep many people on furlough. And some people may choose to stay on furlough rather than fill vacancies. Finally, workers who could fill the vacancies may lack the required skills as COVID has shifted labour demand within sectors
- The mismatch appears to be largest in the hospitality sector, where there were more vacancies than there were on average in 2019[1] even though a quarter of workers in that industry were still on furlough
- The data also suggest that some sectors are seeing stronger demand than others: vacancy rates are high and furlough rates low in the energy and water sectors, while the opposite is true in transport and retail trade
- The bottom line is that labour market frictions are likely to have increased the UK's structural unemployment rate for now, meaning that wages pressures could rise sooner than otherwise expected despite ongoing signs of labour market slack

[1] We have expressed vacancies as a share of the 2019 average rather than as a share of total employment since vacancy rates tend to differ by industry – for example turnover in hospitality tends to be higher than in other industries.

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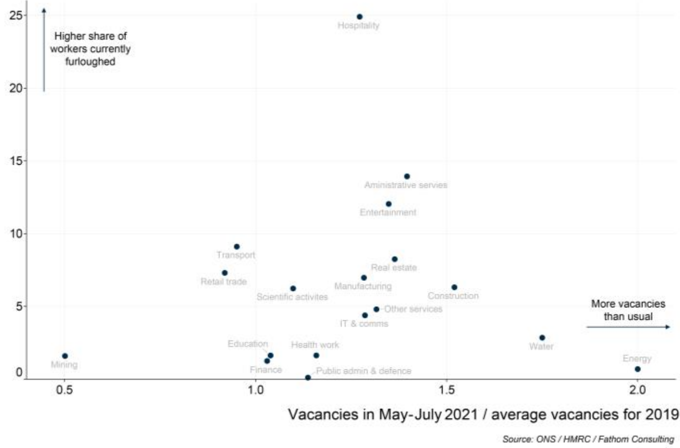
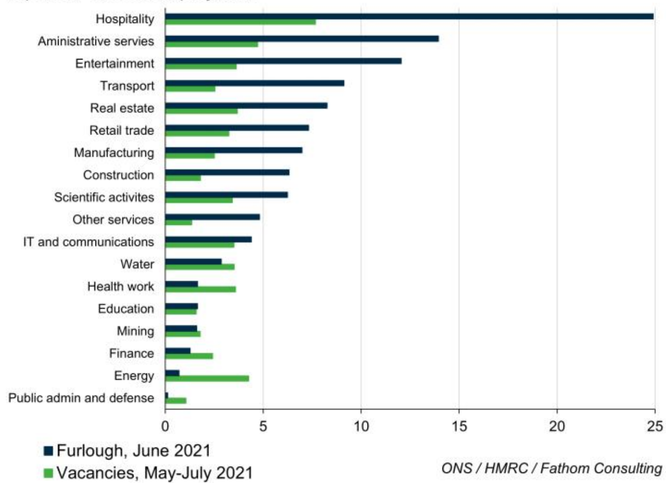
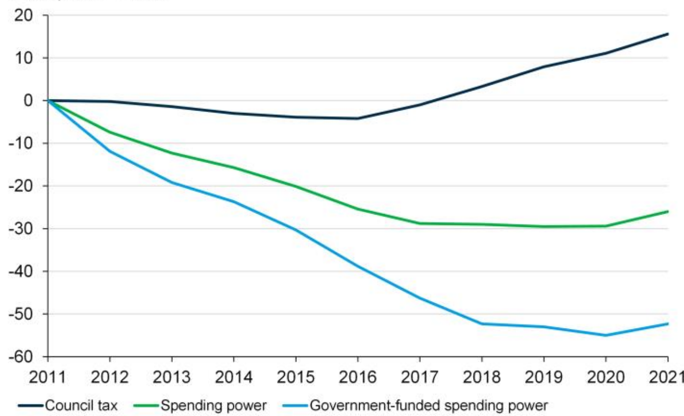

UK vacancies and furlough
Staff on furlough, proportion of employment, June 2021
Higher share of workers currently furloughed
More vacancies than usual
Hospitality
Aministrative servies
Entertainment
Transport
Retail trade
Real estate
Scientific activites
Manufacturing
Construction
Other services
IT & comms
Water
Education
Health work
Mining
Finance
Public admin & defence
Energy
Vacancies in May-July 2021 / average vacancies for 2019
Source: ONS / HMRC / Fathom Consulting

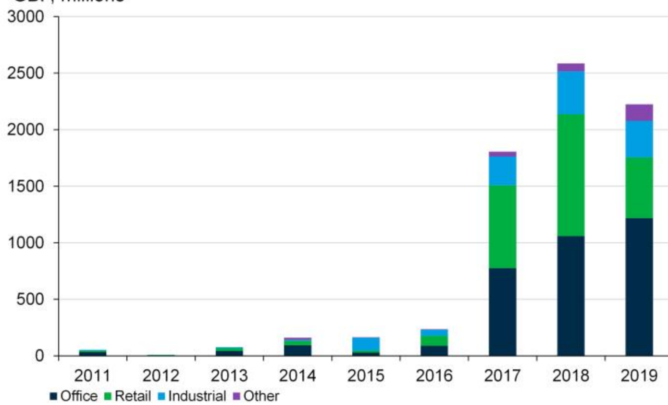

UK vacancies and furlough
Proportion of total employment
Hospitality
Aministrative servies
Entertainment
Transport
Real estate
Retail trade
Manufacturing
Construction
Scientific activites
Other services
IT and communications
Water
Health work
Education
Mining
Finance
Energy
Public admin and defense
Furlough, June 2021
Vacancies, May-July 2021
ONS / HMRC / Fathom Consulting

Austerity, then COVID: the double whammy

- In July 2021, Slough council became effectively bankrupt due to a £100 million shortfall in its budget, making it the third UK local authority to become insolvent in the past three years — more could follow suit
- Over the last ten years, a halving in UK central government funding to councils has only been partially offset by increased council tax, leading to a net 26 per cent reduction in overall council spending



- This extended period of central government austerity has pushed some local councils into risky investments in an attempt to close funding gaps, with commercial property (particularly office space) having seen a big increase in recent years



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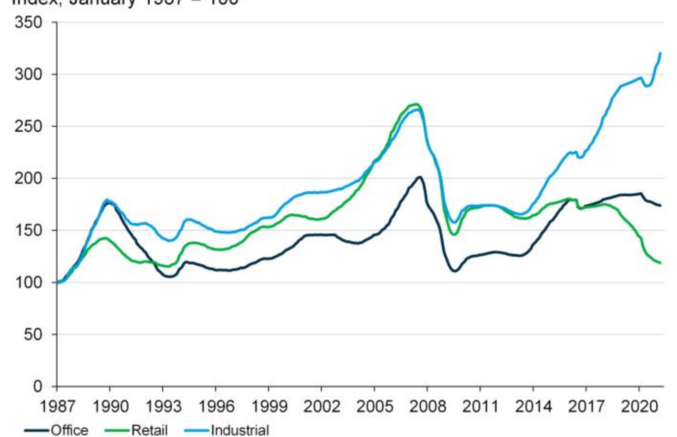

- These investments now look especially perilous in the light of changing work patterns brought about by COVID, and we believe that the risks to commercial property, in the near term at least, remain firmly to the downside
- While commercial income makes up only a small share of local authority budgets, investment losses could exacerbate the existing funding squeeze, posing financial risks that could, ironically, end up back on the central government balance sheet

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