Monthly

Economic Review

Provident Solutions
Wealth Creation & Wealth Management
Financial Lifestyle Planners

Economic review of: April 2011

Our monthly economic review is intended to provide background to recent developments in investment markets as well as to give an indication of how some key issues could impact in the future.
It is not intended that individual investment decisions should be taken based on this information; my colleagues and I are always ready to discuss your individual requirements. I hope you will find this review to be of interest.

Paul Smith

With the local government elections (and AV referendum) due within a few days, we can expect more political point-scoring. This will probably centre largely on national, rather than local issues, since the media are more likely to report on issues that affect the largest number of people.

Mediterranean weather may have helped consumer spending in April

It was slightly surprising, however, to hear Ed Balls – who as Chief Secretary to the Treasury was largely responsible for taxation policy during the last administration – describing the 6th April as "Black Wednesday" because of the rise in families' tax burden, when the largest constituent of this was the 1% rise in National Insurance contributions bequeathed to George Osborne by his predecessor.

Higher taxes, like inflation, are a major contributor to the squeeze on families' budgets, because of the adverse impact on spending. But while the fantastic weather most of us have enjoyed throughout much of April – and the Royal Wedding at the end of the month – will undoubtedly boost retailers' figures when they are published in due course, what really matters is not so much how the high street (or internet) is performing, but what is going on in manufacturing.

Britain simply has too small a manufacturing base. Relative weakness of sterling during 2010 should have led to an export driven recovery; but industrial output is still only about 90% of the 2006 level, while services output is above 100% of its level at that time.

Perhaps that is why the 2011 Budget focussed on helping business to recover, rather than concentrating on giveaways to consumers. In the end, this is more likely to help.

Export or die?

While it may be an exaggeration to say that we cannot survive without a strong manufacturing and export sector, it is certainly true that we would be better off if we made and exported more. However, we have few natural resources so we have to import most raw materials. It is therefore the 'added value' in what we manufacture that matters; if sterling strengthens, as it has recently, imports become relatively less expensive, but our exports become more so.

Exporting is essential, if we are to reduce reliance on services

An example of how dependent UK manufacturing appears to be on imports is the motor industry, where a shortage of parts from Japanese manufacturers caused by the earthquake, tsunami and subsequent nuclear crisis has made it difficult for some UK plants to operate at a level of capacity consistent with potential demand.

Interestingly, for the first time since records began in 1998, more of our exports went to non-EU destinations including the US, Middle East and China, during February than to EU member states. Looking at the growth rates in several of these territories compared with the financial crises in Portugal, Ireland, and Greece, this could be excellent news, if it continues.

Exports in February reached £30.7 billion – the highest month since 1980, but the trade deficit was still £2.4 billion, £6.8 billion if services such as banking and insurance are excluded (but still £1 billion better than January).

Economic growth

Following a reduction in the estimate of how much GDP fell during 4Q10, the Office for National Statistics has just released its first estimate for the 1Q11 at a widely-expected 0.5%. This comes as a massive relief to those who had feared a combination of cuts in Government spending and higher VAT would tip us back into recession – the so-called double-dip. It is also a better trend than the US, where 1Q11 annualized growth of 1.8% compared with 4Q10's 3.1%. In fact, had it not been for poor construction output, the UK figure could have been about 0.3% higher than the actual result.

You can't make an omelette without breaking some eggs

Actually, George Osborne has warned that we are not out of the woods yet and over-confidence would be a mistake, especially as some of the return to positive figures could be due to a bounce-back after the bad weather of late last year.

Good news came earlier in the month in the form of positive feedback contained in the Purchasing Mangers' Index – important because this shows how those buying goods for manufacture and construction view the short-term economy. This rose from 52.6 in February to 57.1 in March (anything over 50 indicates expanding purchases).

Conversely, less positive indicators include a cut in the OECD's estimate of our growth for 2Q11, from 1.3% to 1% (compared with 2.9% for the rest of the G7, excluding Japan). It has also been pointed out that the high price of oil could still undermine recovery, which is why we can expect to see increasing pressure on OPEC to up production.

Markets (Data compiled by the Insurance Marketing Department Ltd.)

The FTSE100's 2.73% recovery during April was by no means uniform, with an early bounce-back hampered by Portugal's debt downgrade and yet another earthquake in Japan. However, relatively good jobs data in the US – somewhat tarnished by subsequent warnings that the US debt situation must be addressed or there could be a downgrade there too – helped all the main indices we track to grow over the month. The FTSE250 gained 3.64%, while AIM ended 2.19% higher. This leaves the mid-cap market almost 16% up on a year ago and the FTSE100 index over 9% higher.

Reasons for cautious optimism

Elsewhere, the Dow Jones gained 3.98% and the Nasdaq100, 3.32%, leaving them both over 16% higher than a year earlier. Similarly, the Eurostoxx50 gained 3.45% and Japan's Nikkei225, 3.05%; the latter index is – perhaps unsurprisingly – the only one of our tracked indices to be lower than a year ago (by 9.5%).

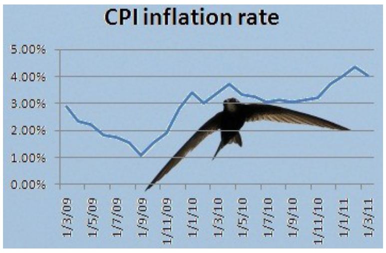
One contributory factor to the UK markets' recovery might be that dividends were 10.3% higher in the first quarter of 2011 than during the corresponding period of 2010, which is bound to have boosted confidence.

Oil prices have distressingly risen even higher and ended April at $125.89 a barrel for Brent crude 1-month futures, some 9.35% up and a massive 44% higher than this time last year. Sterling is also almost 19% higher against the US dollar than a year ago, which is not good for exports, but 2% down against the euro, which does help. However, since many of our commodity imports could well be in dollars, the overall impact could be one reason why manufacturing managed to grow by 1.1% during 1Q11.

Gold ended April 8.67% higher at $1,559.15, having hit an all time high of $1,569.35 just before the end of the month.

Inflation and interest rates

The sudden fall in CPI inflation, during March, was most welcome but should not be seen as automatically indicating that this threat is under control. Some may argue that inflation is necessary and can be managed; but for those on fixed incomes, especially pensioners, it is something that cannot be managed, only endured.



One swallow does not make a summer

Nevertheless, it is to be hoped that this is the start of a trend, despite the fact that we now appear to be importing inflation from China, as well as having our own oil- and VAT-driven version. Conversely, the fact that prices are rising in the country that seems to make just about everything in our shops today, could mean that repatriating manufacture to the UK could become a cost-effective option for some businesses.

Interest rates round the world		
UK	0.50%	No change for 25 months
USA	0.25%	No change for 28 months
Europe	1.25%	+0.25% April 2011
Japan	0.10%	No change for 28 months

The fact that the European Central Bank has 'broken ranks' and increased interest rates by a quarter basis point to 1.25% may not indicate that we are yet due for a rise in the UK. Here, despite ongoing enthusiasm for a rise from Dr Andrew Sentance (whose last Monetary Policy Committee meeting will be in May) the Bank of England appears reluctant to make any moves that could slow the recovery. Its view may be that inflation will fall of its own accord and that it need not pressurise businesses and families by increasing the burden of interest rates.

Perhaps the voices of two other members who voted for a smaller rise will be heard; but this seems unlikely – at least, in the opinions of many people, before August. Similarly, Adam Posen's call for a £50 billion boost to quantitative easing (so-called 'printing money') may also continue to go unheard.

International debt

Portugal, the latest Eurozone country to apply for an emergency loan, has had its long-term credit rating downgraded by Moody's from A3 to Baa1 (not much above junk status, in simple language). This is worrying partly because of suspicions that Greece will soon have to seek fresh lines of credit, or risk defaulting on its borrowings. Greek bond yields – effectively the cost of its borrowing – have recently exceeded 12%, compared with less than 4% for Germany.

Portugal may soon need its historic battlements

It is not safe for us to stand back and "make sport of our neighbours" (to slightly paraphrase Jane Austen's Mr Bennett). The principal reason we are not currently under threat of having our sovereign debt downgraded is that it is longer term than that of many other countries. Unless the UK Government's debt-reduction plans are successful, we could well face the prospect of seeing our ratings slashed – and interest rates hiked as a result. Should this happen, repayments could sky-rocket overnight, slashing the money for spending on schools, hospitals, defence ...

The other reason we are currently able to retain our credit rating is that the coalition is seen to be taking positive (and largely unpopular) action to slash our debt. Countries where unrest has made such actions difficult are paying the price.

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