Monthly

Economic Review

Provident Solutions

Wealth Creation & Wealth Management
Financial Lifestyle Planners

Economic review of: August 2010

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

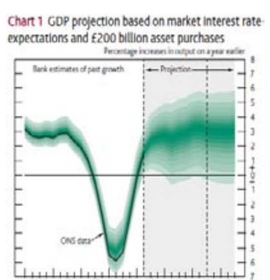
One of the recurring themes during August has been the lack of confidence amongst both consumers and businesses (although according to GfK/NOP, consumers are now less pessimistic than a month ago). In general, this appears to be based on fears about the impact that falling government spending could have on jobs.

Balance between confidence and over-optimism is essential

Underlying data do not, however, necessarily support pessimism; negative sentiment could do more damage to economic recovery than anything. Double dip recession could become a self-fulfilling prophesy, if we are not careful. Measured in a recent survey by the Institute of Chartered Accountants and Grant Thornton, business confidence has fallen from just about a six-year high, to its lowest level since the recession. Just over half the respondents were more upbeat about economic prospects, but one in five was far gloomier – almost 50% more than three months earlier. Almost half of all consumers questioned expect their financial positions to worsen. There are surveys, such as one by Lloyds TSB, that suggest exporters are more confident, but the overall impact of a slow housing market appears to be sapping consumers' confidence – at least when questioned. Conversely, retail sales for July were actually 1.1% up, compared with forecasts of just 0.4% - which rather reinforces the fact that opinion is more negative than behaviour.

Economic forecasting

The Bank of England makes extensive use of 'fan charts' when looking at inflation and growth. The reason for this is that forecasting is an inexact science (in fact if Professor JK Galbraith is to be believed, it is more of an art form) so, if forecasts are to be realistic, it is essential to reflect the fact that the further you look into the future, the more widely circumstances could vary the outcome from forecasts.



"The only function of economic forecasting is to make astrology look respectable" (JK Galbraith 1908 - 2006)

The importance of forecasts is therefore not that they tell us what will happen, but that they set the framework within which decisions can be made. For example, Bank of England Governor Mervyn King apparently told the Sunday Times' David Smith (22/8/10) that even with the benefit of hindsight, he would probably have acted no differently 18 months ago than he did, based on what have turned out to be inaccurate forecasts.

In fact, getting forecasts wrong can actually serve as an early indicator that the underlying performance of the economy has changed – which is important because the policy blunders of the 1970s resulting in double digit inflation were partly due to the fact that policymakers did not realise that there had been a step change in productivity growth. In other words, by recognising the existence of forecasting errors, policymakers should be able to tell that previous assumptions about inflation and employment levels, for example, may no longer apply – and that they may have to change the way they plan.

At least the Bank has responded to conditions by revising its growth forecasts down and inflation forecasts up; the data look more realistic and, although food and fuel costs generally are rising, the rest of the inflation data look to be moving the in right direction. In fact if you ignore the impact of higher indirect taxation, inflation could be seen as only about 1.4%. But they are still probably over-optimistic on growth, so we are still near the bottom of the fan chart.

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

It is hardly surprising that, after July's across-the-board market rises, August experienced more muted markets, particularly in view of an apparent trend of investors to move towards government bonds as a defence against possible double-dip recession both sides of the "pond".

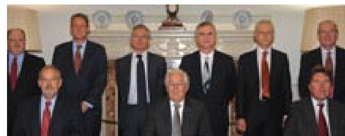
Japan continues to be a weak performer

To be fair, data in the US has probably been worse than here, with downbeat comments from the Federal Reserve and poor housing data. The FTSE lost just -0.62% of its value in August, leaving it some 6% higher than a year ago, while the mid-cap FTSE250 lost -1.24%, although it is still more than 11% higher than this time last year. However, overseas markets fared much worse, with the Dow Jones shedding -4.31%, and the Nasdaq100 some -6.24%. While the Eurostoxx50 mirrored the Dow Jones at -4.35%, worst performer of the indices we follow was Japan's Nikkei225, which lost -6.72% during August.

Sterling had a mixed month, falling -2.08% against the US dollar, but gaining 0.59% against the euro (which correspondingly fell compared with the dollar). As so often in times of uncertainty, gold rose, in this case by 5.65%, but oil prices fell during August by -2.02% to US$76.60 per barrel for Brent crude 1-month futures.

Interest rates and inflation

Some people, including the Monetary Policy Committee's Andrew Sentance (who remains a lone voice for the moment) suggest that interest rates need to rise in order to combat the growing threat of inflation. The principle is that if borrowing becomes more expensive, people will be less inclined to buy, which will slow what is called 'demand-pull' inflation. This, however, ignores the fact that some inflation is fuelled by rising costs (including the cost of borrowing) which manufacturers have to pass on to consumers – called 'cost-push' inflation. The argument for higher interest rates also ignores the adverse impact that potentially resulting higher prices would have on GDP, which currently remains robust.



The team managing our interest rates

Conversely, one positive effect of the credit crunch is that businesses seem to be finding alternative ways of financing themselves, so that they are less reliant on bank lending. In addition, higher interest rates would help savers, particularly the elderly, who tend to rely on income from their cash savings.

Interest rates round the world		
UK	0.50%	No change for 17 months
USA	0.25%	No change for 20 months
Europe	1.00%	No change for 15 months
Japan	0.10%	No change for 20 months

Government debt

One positive economic indicator is that government borrowing fell in July (from £6.1 bin in 7/09 to £3.8bn in 7/10). So far this year, since April, overall government borrowing is also £2.6bn lower, although total net debt is £816.2bn, which represents some 56.1% of GDP which is much higher than the previous July's 47.7% of GDP. On the other hand, the public sector budget deficit has fallen by £3.3bn.

However, it is not yet clear that sufficient is being done to reduce debt because credit rating agency Moody's says the recession has reduced the amount of time before the UK is expected to run into financial problems caused by the ageing population. The reason for this is that there will be fewer people to pay taxes, compared with the number of people receiving benefits, meaning that spending could exceed income by an even larger margin than today. One of the reasons that we are not currently suffering from this problem is that our debt is owed over a much longer timescale that that of Greece – but this position will not remain for ever. According to Moody's (which has just downgraded Ireland's sovereign debt by a further notch), our "AAA" rating is at risk on the basis that public debt could still reach 90% of GDP by 2013. So any slackening in financial tightening could result in loss of status and higher borrowing costs – a downwards spiral.

Continuing to tighten the screw remains a priority

Banks

The banks have been facing criticism recently on a number of fronts ranging from not lending enough (money is on offer but the terms can sometimes appear draconian) to charging too much interest at a time when the wholesale cost of money is falling. In fact, one reason why the cost of wholesale money is getting cheaper is that the banks have been building up their reserves in order to give greater protection to investors should there be another banking crisis. Unfortunately, there is insufficient retail saving to finance banks' operations, so they have to rely on international markets.

Banks are essential to us all

It is not our task to write an apologia for the banks; but it is worth recognising that they are vital to the economy – not so much because of the invisible earnings and tax revenue they generate for us, but because, without them, we simply could not operate at all; no banking, shopping, investments or insurance.

In any event, since we own a huge chunk of several of them, the more profits they make, the better the return we taxpayers can expect over the longer term. If one price of this is high bonuses for the few people who generate most of the profits, then perhaps that is something we should live with?

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