Monthly

# Economic Review

Provident Solutions
Wealth Creation & Wealth Management
Financial Lifestyle Planners

## Economic review of: August 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*

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**The two leading stories during August were the unfolding financial crisis in the Eurozone – not to mention the loss of AAA rating in respect of the USA's sovereign debt – and the rapid developments in Libya.** These are highly relevant to investors for several reasons.

*When the dust settles, matters may improve*

First, Europe, where questions are being asked whether frequent meetings between France and Germany – undoubtedly the strongest economies within the Eurozone – will be adequate to stem the ever growing crisis within the currency, based not just on the mountains of bonds held by banks in the more stable countries relating to debts in southern Europe. There appears to be a general consensus that some or all of Greece, Italy, Spain and Portugal could default on their borrowings because they simply do not have sufficient money to cover their repayments and cannot cut spending – or raise taxes sufficiently - to cover the shortfall.

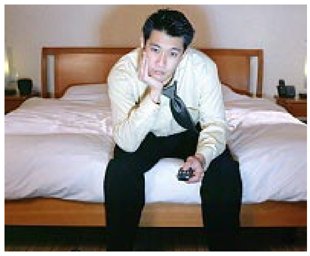
The Eurozone needs a strong and reliable bailout package ready in place to step in with should a member government collapse. Whether this can, or should, include private sector investors is something that remains to be seen, should it ever get off the ground. The UK cannot afford to see the Eurozone fall apart; it is a major trading partner and our recovery is highly dependent on developing additional markets there. Unfortunately, Germany's second quarter performance was even worse than that of the UK at 0.1% growth, compared with our 0.2%. Given that its first quarter performance was well above the Eurozone average, this could be an aberration; we certainly hope so.

The USA is our other major trading partner and the loss of its highly valued AAA rating (for the first time ever) will have discouraged domestic markets even if it has not – as we had feared – actually resulted in interest rates being hit. In fact, money appears to have continued, perhaps slightly perversely, to pile into US government bonds, in addition to Swiss bonds and gold (which slumped near end-month).

The second point is that developments in Libya, which may seem remote from UK economic issues, could be very important to us. The expectation that oil production will be stepped up when normality returns to the country has already put downwards pressure on oil prices and this could help our efforts to keep inflation under control here. In any event, stability there could lead to increased trade as the country seeks to recover from six months of civil war.

**Bad news sells papers …**

**… and attracts television news viewers;** this could be why we tend to read and see negative messages about the economy all the time. However, if you look at the Bank of England Agents' summary of business conditions for August, there is a more positive, if mixed, message. Gathered from personal and group meetings throughout the UK every month, this report represents the views of real businesses and is a measure of confidence (or otherwise) just as much as based on the empirical performance of individual companies.



*Do I really want to watch this?*

The August report reflects weak demand at retail level, leading to earlier and deeper summer sales, with only food and other essentials remaining strong. However, while consumer turnover has remained weak overall, areas such as public transport have benefited due to people seeking to reduce motoring costs. Domestic tourism has also benefited from a switch away from foreign holidays, while overseas visitors to the UK have also boosted sales.

The level of growth in the vital export sector has slowed, but still remains positive, with sales to emerging markets growing strongly. There has also been an interesting – and valuable – trend towards luxury goods in preference to investment goods, which could help over the long term. In the services sector, while public sector work has slowed, private sector activity has more than outweighed this with IT companies in particular benefiting from firms seeking efficiencies through better use of technology. Overall, the rate of growth in manufacturing has slowed over recent months, but remains positive; even construction output has benefited from some sizeable infrastructure and energy related projects (especially the Olympics).

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

**The words 'roller-coaster ride' are probably overused in relation to stockmarket movements;** after all, volatility is one of the main characteristics of any market that is driven as much by sentiment and confidence as any considerations of the underlying performance of businesses. That said, August, which saw the FTSE100 end -7.23% lower (having fallen almost twice as much during the early part of the period) and the Eurostoxx50 -13.97% lower, has probably been one of the most volatile months for some time. The principal reasons for these movements are discussed above; fears over the future of the Eurozone and hopes that events in Libya will result in increased oil production. (Oil prices fell as low as about $103 per barrel during the period, but ended only -2.33% down at $114.02.) Other factors were the fear that recession could return, although this is not a widely held fear, and poor data from the US early in the month.

*When Uncle Sam sneezes ...*

The partial recovery towards the end of August was driven largely by better US consumer spending figures and relief that Tropical Storm Irene caused less damage to the East Coast of America than had been feared. Finally, hopes that the US will implement further quantitative easing (QE3, as it has become known) led markets upwards to the extent that some investment banks are tipping the FTSE100 to end 2011 above 6,000 points.

The Dow Jones fared better than some other leading indices, losing just -4.36% over the month, in movements broadly reflecting those of the FTSE100. With the exception of the Eurostoxx50, all the main indices we track are still in positive ground over twelve months.

Gold, one of the most popular bolt-holes when markets are uncertain, ended August 12.52% higher at $1,816.29 per troy ounce, but had actually breached $1,900 during the month, before falling back. Sterling fell by -1.15% against the dollar over the month, but is still almost 5.5% higher than a year ago.

## Inflation and interest rates

**Inflation will increase further before it falls back, according to the Bank of England's August Inflation Report.** In fact CPI inflation, currently standing at 4.4%, could easily hit 5% before the end of this year, before gradually returning to its 2% target by some time in late 2012 or 2013, the Bank believes. The principal malignant factors are likely to be energy prices, although oil prices may soften if Libya gets back to full production soon.

*Manufacturing is essential to growth*

| Interest rates round the world | | |
|---|---|---|
| UK | 0.50% | Last change – March 2009 |
| USA | 0.25% | Last change – Dec 2008 |
| Europe | 1.5% | Last change – July 2011 |
| Japan | 0.10% | Last change – Dec 2008 |

Although it needs to bring inflation under control, the Bank's Monetary Policy Committee appears to believe that the threat is largely imported and that raising interest rates – the traditional way of fighting inflation - is not viable, due to the adverse impact that this could have on growth. The MPC vote for August was therefore unanimously for a hold, which is a dramatic softening of views from a month or so earlier. Indeed, it hinted that it could even restart its quantitative easing (so-called money-printing) programme as it grapples with the various economic threats posed by turmoil in the Eurozone.

Some commentators are even predicting that there could be a further cut in the base rate, within the next six months, to as low as 0.25%; certainly an increase in base rate now appears unlikely for another eighteen months. Not much cheer for savers.

## Public sector debt

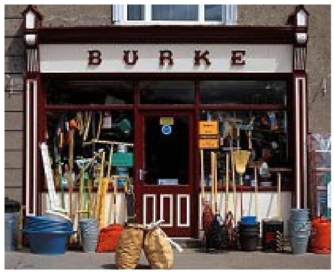
**At a time when personal debt continued to rise at just under 1%, the public sector net borrowing requirement for July 2011 fell dramatically** from £3.5 billion a year ago to £20 million. This has resulted from a £660 million windfall from the bank balance sheet levy and larger corporation tax receipts, as well as lower local government spending. Total borrowing for the year to date (from April) is now £40 billion and is forecast by the Office for Budget Responsibility to be £122 billion for 2011/12. It is not clear whether the target of eliminating the budget deficit by 2015 is possible; much will depend on whether the economy grows sufficiently to generate enough additional tax revenues.

*Cutting spending - and repaying debt - is essential*

With the economy threatening to slow even further, there is clearly a temptation to give it a quick boost by slashing VAT back to 17.5%; unfortunately, such a move could easily be interpreted by the credit rating agencies that have just down-rated US sovereign debt as indicating that we no longer have the political will to combat our debt mountain. Were they to downgrade the UK's credit rating, we would almost certainly suffer far worse than our American cousins and experience an upwards spiral in interest rate costs – making repayment even more difficult. This is no time for quick fixes.

## Help for the High Street?

**One interesting side-effect of high inflation is that shoppers appear to be eschewing their cars** and taking to the High Streets, again. Data from the British Retail Consortium suggest that, with the exception of areas where the public sector is the largest employer, consumers are making more shopping trips, but spending less on each. The effect of this, the consortium says, is that they are avoiding out-of-town retail parks and are instead drifting back to High Streets.




*Hope for small retailers*

There has been a 1% reduction in overall 'foot-fall' between May and July this year, but the impact on shopping centres (up 0.6%) and local shops (-1.6%) is lower than on retail parks (-1.9%). It would be good to see town centres being revitalised and, hopefully, reclaimed from the hoodies.

One thing that might help smaller retailers is (as reported some time ago) that cheques are no longer to be phased out by 2018. In a recent development, the Parliamentary Treasury Select Committee has recommended that the Payments Council – the body that had tried to scrap cheques – should have its wings clipped and be brought within the regulatory system. Its further recommendation that the cheque guarantee card should be reintroduced will be welcomed by many small traders.

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