Monthly

Economic Review

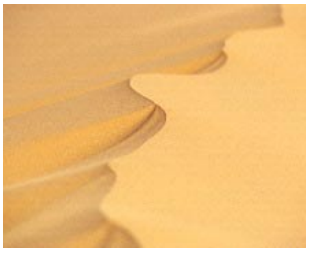
Provident Solutions
Wealth Creation & Wealth Management
Financial Lifestyle Planners

Economic review of: February 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



So much more than sand

The situation in North Africa and the Middle East is something that is likely to affect us all. While many will welcome an expansion of democracy into parts of the world that may not previously have enjoyed its benefits, there are issues that are likely to impact on the world wide economy in general and the UK in particular. We are, after all, major traders in the area and this relates not just to the all-important oil, but also to defence as well as banking and other retail and financial areas.

Over the shorter term, the disruption involved in civil unrest had already had its impact on equity markets, gold and oil prices. This is likely to get worse, should the movement for self determination gather pace, and at a time when at least some of our inflation is "imported", timing could not be worse for the UK economy. Higher inflation may force up interest rates (see article below) in an attempt to cap at least the domestic element of this potential threat to stability.

Another key issue is, however, what will replace the fallen regimes over the longer term? A move to Western-style democracy may not produce the type of government with which we are familiar – or might be comfortable. But at the end of the day, it is each nation's right to self determination that matters. Islamic republics are not necessarily something that should concern the West, although an increase in 'radicalism' might make trading conditions more difficult. Any form of stability is likely to be beneficial to the global economy, so it could well be that, once the dust has settled, we are in a stronger position than before.

Consumer confidence

While the Bank of England (BofE) agents' summary for February indicates that retail sales rose slightly during January high street retailers have warned that consumers are cutting back on spending in the face of government austerity measures and the increase in VAT.

Retailers are suffering from lack of confidence

According to The Times (23/2/11), consumer confidence is now at its lowest level since June 2008 and the largest fall in sales is seen where public sector jobs are likely to be worst affected by cuts. John Lewis, often seen as a barometer for high street spending, reports that in areas where fewer than one in six workers are employed in the public sector, sales were 4.3% up during the six months to 22nd January, whereas those areas with a higher proportion of public sector employees saw a fall of 2.1%.

A less pessimistic view might be to note that retail sales in January, while perhaps largely showing a 'bounce back' from the late December snow, actually look relatively positive compared with the trend over 2010. In fact, the level appears to be about 9% higher than in 2006 (The Times 19/1/11).

Inflation and interest rates

Could inflation go sky-high?

With CPI inflation hitting 4% in January (5.1% for the RPI, which also includes housing costs amongst other things) the BofE Monetary Policy Committee (MPC) faces a challenging few months. While it is argued that much of our inflation is caused by rises in the price of raw materials and imported goods, the fact remains that there is a danger that collective bargainers will see this as a reason to start seeking higher wage settlements, in compensation. This would be disastrous for the economy because it would start a domestic inflationary spiral that would fuel external trends and make it even more difficult to combat.

Interest rates round the world		
UK	0.50%	No change for 23 months
USA	0.25%	No change for 26 months
Europe	1.00%	No change for 21 months
Japan	0.10%	No change for 26 months

The February MPC vote was split over a rate rise, one additional member now voting for a rise. Spencer Dale joined Martin Weale to vote for a 0.25% rise, while Andrew Sentance voted for a 0.50% move upwards. The minutes of February's meeting show that Governor Mervyn King voted with five other members to hold the rate at 0.5%.

While many savers would like to see rates increase – it is currently almost impossible to beat inflation with bank deposits – the impact on the economy could be to tip it into technical recession (two consecutive three-month periods of negative growth) if rates were raised too quickly, by too much.

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

Higher oil prices do not just affect motorists; they can slow economic growth

February was a somewhat rocky month for markets, due to political turmoil first in Egypt and latterly in Libya. The FTSE100, which reached a high of 6,105.80 on 21st February, fell back to end the month just short of the 6,000 mark, 2.24% up over the month. On the other side of the 'pond' the Dow Jones fared similarly, falling back from a high of 12,417.97 on 18th February, to finish the month 2.81% higher. In fact, all the main indices we track ended February higher than they started it, with the exception of the AIM, which lost -1.11%; given that this index has outperformed the FTSE100 every month since last August, a minor reversal is hardly surprising.

Rapidly rising oil prices - driven by fears that Colonel Gaddafi could hang on for a long time - ended the month 12.97% higher at US$112.14 per barrel for Brent crude 1-month futures. This was a major depressant on share markets during the last week of the month. Uncertainty over oil supplies could have wider economic ramifications than simply depressing share prices, possibly resulting in higher 'imported' inflation. Gold – so often a 'bolt-hole' for investors – also gained 5.63% during the month to finish at US$1,413.73.

Sterling continued its three-month rally against the dollar and its two-month rise compared with the euro, which will not help exporters, although it makes imports slightly less expensive.

Employment

Will new job creation be suitable?

To some extent, the spectre of rising unemployment may make an increase in interest rates less likely – although whatever happens, we all probably face a period of belt-tightening to an extent we have not experienced for many decades. However, employment rates are currently holding up well, compared with those at the start of the recession, so there is some cause for cautious optimism, even as government cuts start to bite.

The BofE agents' summary for February shows positive employment intentions in manufacturing and services and suggests continued growth in jobs – at least within the private sector – for some time. In fact, the intentions figure is the highest since the start of the recession. Whether this is adequate to counter public sector job losses with the right sort of employment will remain to be seen.

Business

We must increase our exports

One major disappointment, over the past year, is that the relative weakness of sterling has failed to help exporters close the trade deficit. Although matters improved during 2009, and it looked as if we had finally turned a corner, the picture declined throughout 2010. By the end of the year, total imports exceeded total exports by over £46 billion, compared with less than £30 billion at the end of 2009. If goods alone are taken into account, the deficit was more than £97 billion, compared with just over £82 billion in 2009.

Clearly, we need a coherent plan for growth; especially as we now see that GDP fell by 0.6% (rather than 0.5%) during the final quarter of 2010.

One country that appears not to be suffering is China, which has overtaken Japan as the world's second largest economy, with GDP of US$5.8 trillion, after Japan's economy shrank at an annualised rate of 1.1% during the final quarter of 2010. The fact that India and China will probably be the largest economies in the world by 2050 should be seen in the historical context that, given their much larger populations, this is simply a return to the pre-industrial revolution period of the late 18th century. In other words, they have simply caught up lost ground, due to comparatively late arrival of industrialisation.

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