

Economic review of:

July 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

At the risk of sounding political our new Foreign Secretary, William Hague, appears to have a real agenda for what may have been seen in recent years as something of a non-job.

We must recognise that the UK can no longer be the world's policeman. Recent reports that the military is to be cut back represent acceptance of what many people see as an inevitable re-balancing of our position within the world. But this is not a defeatist approach suggesting that we have no place in the world. It is rather the reverse, giving ourselves the room to focus on what we are really good at; innovating in business and acting as a world power in economic terms. We may not be as large as the USA, or growing as quickly as India and China, but as Mr Hague has clearly recognised, we have a great track record of creating wealth for ourselves and our trading partners. If we can concentrate our limited resources on this, there is no reason why we should not be able to build on our strengths and have a stronger future economy based on a dynamic private sector, rather than a burgeoning public one.

With the Eurozone - one of our most important trading partners - in difficulties, now is just the right time to be thinking about new areas to export to. Asia, Latin America, the Middle East and the emerging parts of Europe have all been identified as regions likely to have stronger economic growth than the UK for some time to come. Good targets for a re-invigorated Foreign Office?

The Economy

News that the UK economy grew by 1.1% during the second quarter comes as something of a surprise in view of the first quarter's modest 0.3%. Of course, these figures are subject to revision, which could be downwards, but they appear to be based on a



Great Britain mark 2 or 3?

strong recovery in the construction sector (which had been very weak, so its recovery may not be so surprising).

This calls into question earlier predictions that we might be heading for a 'double dip' recession as the previous government had warned, if spending cuts were implemented. This could still happen, but not if the threatened public sector job cuts - essential if state spending (and borrowing) is to be brought under control - can be countered by new jobs in a revitalised private sector. It could be argued that each new private sector job created is worth much more than each public sector one lost; not because of the value we place on the individuals' efforts, but because they tend to create value and contribute to the public purse through taxation, rather than costing other taxpayers more money.

Some people had seen June's stockmarket performance as a precursor to economic slowdown and the housing market certainly appears to be moving backwards. But there are so far few significant indicators that we are in for another reversal. According to the Bank of England's Agents' summary for July, consumer spending slowed during the quarter. Set against this, however, are reports that investment intentions amongst businesses remain consistent with a rise in spending, export volumes have continued to rise at a steady pace and manufacturing output is also up - based on external, more than domestic demand, which is encouraging. For too long have we relied on finance to balance our payments, so a return to a more robust manufacturing base must be welcomed.

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

Just as it would have been unwise to become overly concerned over falling share prices over the previous two or three months, there is little point in celebrating July's impressive bounce back; this is all part of the natural movement of markets, although there are some encouraging indicators. In particular, BP seems to be coming out of the doldrums with its sharp



Construction was the strongest growth area



The sun is breaking through, but markets remain volatile

decline since the Gulf oil spillage having been reversed so some extent. UK Banks also performed strongly during the last few days of the month as capital and liquidity reform packages were watered down. As a result the FTSE100 ended the month 6.94% higher; it might have been even better had investors not become nervous about companies threatened by government spending cuts. The FTSE250 also enjoyed something of a renaissance, rising 6.22% while the Dow Jones ended July some 7.08% higher. Even Europe saw a revival in shares - despite its economic problems the euro rose 7% against the dollar - with the Eurostoxx50 gaining 6.56%.

Sterling gained 5.6% against the dollar, but lost 1.35% against the euro while gold, frequently a safe haven in times of falling share values, lost 4.52% during the month. Oil prices rose by 4.23%.

Prices increased by roughly 0.2% during June, measured by both CPI and RPI; but when you look at the annual figures, the contrast between the two ways of counting is clearer (although lower than last month as inflation slows) with the Consumer Prices Index up 3.2% while the Retail Prices Index, which includes housing costs, is now 5% higher than a year ago.

Interest rates

It appears likely that interest rates will remain at their current low levels - possibly subject to minor alterations - for some time to come. According to the influential Ernst & Young Item Club, interest rates will have to be held down in order to balance the effects of government spending cuts. This is in contrast to the Office for Budget Responsibility's suggestion that rates could rise to 3% by 2014 - still well below the level most of us remember from not so very long ago!



A fine balancing act for the Bank

There are even thoughts that the Bank of England may have to re-start its Quantitative Easing programme. However, the Sunday Times' David Smith suggests (25/7/10) that pumping more money into the economy may not be the solution because QE did not directly assist businesses or consumers in the first place; nor was it expected to. What it did achieve was to help keep bond yields low, which led to improvements across several markets, making it easier and cheaper for private sector borrowing. In any event, one long-term outcome of the credit crunch could well be that businesses stop relying so heavily on banks for finance and instead seek alternative sources of finance.

| Interest rates round the world | | |
|--------------------------------|-------|-------------------------|
| UK | 0.50% | No change for 16 months |
| USA | 0.25% | No change for 19 months |
| Europe | 1.00% | No change for 14 months |
| Japan | 0.10% | No change for 19 months |

Andrew Sentance appears to be a lone voice on the Bank of England's Monetary Policy Committee, voting for a second month for a 0.25% rise in base rate. The last person to stand up to the rest of the committee was Professor David Blanchflower - and some people believe that he was right repeatedly to call for interest rate cuts well before these were forced upon the Bank.

Employment

The private sector is good at creating jobs.

Unemployment did not rise much above 2.5 million during the recession and there is no reason to think that it will not be possible for the private sector to take up the slack created by public sector cuts. The Office for Budget Responsibility is forecasting the creation of some 1.34 million jobs over the next five years - and this allows for a cut of more than 600,000 government jobs, so the private sector is actually being asked to create some 2 million jobs during that period. On past experience, many will consider that this is not an unachievable 'target', particularly since manufacturing appears to have carried the brunt of job losses during the recession and therefore has ground to make up during the recovery.



Cause for confidence

Tax simplification

Reports that the Treasury is to establish an Office for Tax Simplification will be taken as good news by most people. After all, one of the main complaints of businesses and entrepreneurs in particular has been the fiendishly complicated tax system we suffer from. And this is something that all parties must accept responsibility for because it has been getting steadily worse for many decades. However, those with any experience of pension simplification will be forgiven for fearing the worst, because the regime we have now for retirement planning is even worse than before 2006 - if possible.



Scrutiny may produce unpleasant results

If simplification does appear, it is likely to be in the form of removing many exemptions and reliefs that we have become accustomed to. If the overall burden of taxation falls, then there is no problem. But the likelihood of that happening in the current economic climate is remote and we must be vigilant to ensure that the Treasury does not simply use this as an excuse to settle some old scores over issues where it has failed to extract the maximum from us (as in the Arctic Systems case, when the taxman failed to stop a husband and wife from sharing their income for tax purposes).

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