Monthly

Economic Review

Provident Solutions
Wealth Creation & Wealth Management
Financial Lifestyle Planners

Economic review of: July 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

Once again, the debt crisis in Greece has held the headlines throughout much of the month. The UK may not be directly involved in the €109 billion deal, but our banks are likely to be amongst those private sector investors who have to reduce the interest rates they charge – which had been hiked in anticipation of a default – and will therefore have lower income expectations. On the other hand, the higher rates reflected the possibility of a default, which now looks less likely (but not, perhaps, impossible).

Good money after bad? Probably not

From the UK's perspective, we simply cannot afford to see the euro dragged down by one or two countries which with benefit of hindsight should, arguably, not have been allowed in at all. Europe and the Eurozone are major trading partners of ours; if they go into a euro-collapse driven recession, we will suffer.

One side effect of the deal is that we have also had significantly to reduce the interest rate charged on lending to the Republic of Ireland, so there is also a direct impact on the Treasury from the deal.

More worryingly, in the US, Republican Tea Party politicians have been playing 'brinkmanship' with Democrat President Obama in what is clearly a manoeuvre looking more at next year's elections than the state of the economy. They had refused to allow the government to extend its debt, thus enabling it to remain solvent; at the very end of July a deal was struck that permits the borrowing limit to be increased in stages in return for a cut in spending, but without tax increases. This could still result in the US credit rating being slashed from AAA, which would probably result in interest rate rises there – potentially weakening the dollar and strengthening sterling (making our exports more expensive).

Economic growth

Figures from the Office for National Statistics show that the UK economy grew by just 0.2% during the second quarter of 2011. Hardly an impressive performance, particularly since downward (and upward, to be fair) revisions are not unknown. However, this is better than some commentators had feared, especially in view of relatively negative feedback encountered by the Bank of England's Agents, as reported in their July summary of business conditions. Both retail sales values and consumer services turnover remain well below their levels at the start of 2010.

A cool nerve will be essential, if errors are to be avoided

On the other hand, there are indications that manufacturers are switching from domestic- to export-related output. Provided the world does not slide back into recession – or if it does, the UK is able to gain market share – this could be far more valuable to the long-term future of our economy than the short-term knee-jerk reaction of cutting VAT back to 17.5%, as is being suggested by Shadow Chancellor Ed Balls – as well, to be fair, as the Federation of Small Businesses, which is not noted for left-wing tendencies.

On a more positive front, job creation appears to be growing, albeit modestly, within the private sector. Overall employment intentions appear to be consistent with last year at a 1% growth rate, but there is far less negativity within the construction sector and business services are more positive. Conversely, manufacturing appears less positive, although in some cases this reflects the fact that firms are operating below capacity and can therefore expand output without undertaking aggressive recruitment.

Official data shows that unemployment fell by 0.1% to 2.45 million during the three months to May.

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

As might be expected after such a tumultuous month, the FTSE100 (-2.2%), Dow Jones (-2.18%) and Eurostoxx50 (-6.25%) all suffered during July, with the mid cap FTSE250 also falling by -3.2%. The US Nasdaq100 fared slightly better, gaining 0.83%, and the Nikkei225 continued its previous month's recovery by adding 0.98%. With the exception of the Eurostoxx50, which is 2% lower than a year ago, the indices we track are all ahead over 12 months, by roughly 10% for the FTSE100, 16% for the FTSE250 and Dow Jones and 22% for the Nasdaq100.

Market recovery hopes were dashed by events in the Greece and then the US

Markets were initially encouraged by good data from the US and the aid package agreed for Portugal, but then fell back over fears about the euro. A rally later in the month followed optimism over the rescue deal for Greece, but markets then suffered as fears over the US debt crisis broadened.

Naturally, gold gained during such uncertain times and rose by 7.59% to end the month at US$1,614.16 per troy ounce. Unfortunately, oil also gained 3.79% to finish July at US$116.74 a barrel for Brent crude 1-month futures; some 49% higher than a year ago.

Inflation and interest rates

UK interest rates are much lower than in Europe

For the second time in three months, the European Central Bank has increased interest rates and these now stand at three times the level in the UK. In doing so, the ECB is reacting not to the debt crisis in southern Europe, but to fears of rising inflation – which is actually running at about two-thirds the rate of ours. The Eurozone growth rate, at 2%, is higher than our annualised 0.8%, so it can afford to take the risk that higher interest rates will cut back growth slightly. Unfortunately, if this reduces demand for British goods, our exporters will suffer.

Interest rates round the world		
UK	0.50%	No change for 28 months
USA	0.25%	No change for 31 months
Europe	1.5%	+0.25% last month
Japan	0.10%	No change for 31 months

It seems that the Bank of England will not be raising interest rates any time soon, as the latest minutes of the Monetary Policy Committee make clear. Some estimates are that there will be no increase before 2014. This leaves the Bank with little in its armoury to fight inflation.

Calls have been made for increased quantitative easing – the modern equivalent of printing money – whereby the Bank of England purchases bonds without selling anything to balance its books. Unfortunately, there is limited evidence that this actually increased bank lending last time round – which was its primary aim – so it is difficult to see how this would benefit the economy. Mind you, the Bank of England apparently made £9.8bn last year on its £200bn quantitative easing programme.

This is a far from esoteric issue. The high street banks must lend more if the economy is to recover from more than a decade of over-spending, compounded by a banking crisis of biblical proportions. David Smith, Economics Editor of The Sunday Times points out (17/7/11) that the problem with the UK economy is not too little public spending, but too little bank lending to the SME powerhouse of the economy. In other words, the problems we face are monetary, not fiscal.

Making more money available to businesses would allow them to generate an export driven recovery, whilst lending more to consumers could help the housing market to recover, which fuels the construction industry. One problem is that many small businesses are afraid to ask their bank for a loan in case they harden the terms on existing borrowing.

Government spending

Can we take away the government's credit card?

One of the most worrying aspects of recent economic data is that government borrowing appears not to be coming under control. In June, the public sector's net borrowing was 14 billion, £400 million more than the same month last year – and for the first three months of the current tax year, borrowing was only £300 million less than the same period in 2010/11. By now, borrowing requirements should be much lower – by about £2 billion a month, compared with last year, so something is going wrong.

The Office for Budget Responsibility, however, is still confident that its prediction of £122 billion borrowings over the full year (compared with £142.1 billion last) is a realistic target. It is independent, so we should trust it – but then statistics are so unreliable that who can tell? Perhaps we should have greater confidence in its rationale, which is that this is all a matter of timing. This year's £3.5 billion bonanza from the bankers' bonus tax will not be repeated, but its replacement, the bank levy, fell due in July. Similarly, while the North Sea Oil windfall is unlikely to be significant this year, January will bring with it the proceeds of the 50p tax rate for the first time. Conversely, weaker growth means less revenue for the government, which means more borrowing.

China

An ageing population could exacerbate other economic threats in China

China is frequently heralded as the powerhouse of world growth, partly as a result of the low cost-base it brings to production, but also because it represents one of the largest potential markets in the world, if demand can be stimulated. It is not, however, insulated against the impact of world events. During the recession, manufacturing output levels fell and they have apparently done so again recently, according to a recent purchasing managers' survey undertaken by HSBC and Markit Economics Ltd. Similarly, new orders for exports during June appear to have fallen below the previous month's level.

Overall, China's economy is expected gradually to slow down during the second half of 2011, as the central government says that it will retain its current mix of tightened economic policies.

Whether in response to this, or not, China's political leadership is understood to be considering ending the country's "one-child" policy because it may be damaging the economy and could lead to a demographic time bomb. If not addressed, the situation could become worse than the pension-funding crisis already faced by Western countries, because with a lower birth rate, the 'support ratio', that is the proportion of those of working age compared with those claiming retirement benefits, naturally decreases more rapidly.

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