ECONOMICREVIEW
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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; we are always ready to discuss your individual requirements. I hope you will find this review to be of interest.

Paul Smith

Sterling hits a six-year high against the US Dollar

In early July, the UK pound (sterling) rose to its highest level against the US Dollar for over five years reaching $1.714. Although it dipped down a little to $1.688 at the time of going to press, it still reinforced its strong performance recorded over the past few weeks. It has gained 11% against the US$ in the past 12 months.

Several factors have influenced sterling's ascendancy; including the fact that the US Federal Reserve (The Fed) reduced its economic growth forecasts for 2014, after experiencing exceptionally bad winter weather, to 2.1 - 2.3%, from a previous higher estimate of 2.8 - 3%. Added to this fact, the Fed has continued to reduce its monthly stimulus measures (or quantitative easing) by $10 billion. This is the fifth reduction since the turn of the year.

Bullish run for the pound

Here in the UK the latest Markit/CIPS purchasing managers' index (PMI) recorded the domestic manufacturing sector at a level of 57.5. This is an increase from the previous month's level of 57.0. Any number above 50 represents growth in the sector and reflects the fact that the UK economy is recovering healthily and that the manufacturing sector in particular is continuing to *"flourish"*.

Rob Dobson, the Senior Economist at Markit, was quoted as saying: *"UK manufacturing continued to flourish in June, rounding off one of the best quarters for the sector over the past two decades."*

All of this good news may well sway the thinking of the Bank of England's (BoE) Monetary Policy Committee (MPC) to raise the historically low base rate, currently 0.5%, sooner rather than later. Many economic pundits have factored in a rate rise being announced by the BoE possibly as early as Q4 in 2014.

The Office for National Statistics' (ONS) latest estimate of UK's Q1 GDP figures was confirmed at 0.8%. It also reported the fastest expansion in business investment here in the UK in two years.

These factors combined greatly increase sterling's attractiveness to currency players.

UK economy hits *"Sweet spot."*

The influential EY Item Club, the non-governmental forecasting group that uses the HM Treasury's model of the UK economy, have stated that the UK's economy will grow faster than any other G7 economy through 2014.

Citing, amongst other factors, the fact that UK wage growth remains subdued and thus the chance of interest rate rises are unlikely until the first quarter of 2015; they predict Gross Domestic Product (GDP) to rise to 3.1% this year, thanks in part, on strong capital investment by businesses.

Peter Spencer, the Chief Economic Adviser to the Item Club, stated: *"low inflation, the strong pound and ongoing risks from the eurozone all suggest caution in raising rates."*

However, this argument is counter to other economists who believe that interest rates may well be raised from their historic low of 0.5% by the Bank of England, as early as Q4 2014.

Peter Spencer went on to add: *"The markets are jumping the gun in thinking that rates will rise this year.*

"Business investment is being ramped up, generating over half of the growth over the last year and helping to rebalance the economy away from consumption.

"Underpinned by a strong labour market that provides the best of both worlds – boosting incomes via employment rather than wages, while keeping inflation low – the UK economy has hit a sweet spot."

Their report concluded that whilst wages are currently rising by only 0.7% (excluding bonuses) which is below the inflation rate (currently at 1.9%), they will start to grow again over the next two years.

The report also forecasts that the UK's unemployment rate, which is currently at 6.5%, will continue to fall to around 5.6% by the end of 2015.

In conclusion The Chief Economist of the Item Club, Mark Gregory, stated: *"After several false starts, this time* (the recovery) *could be different."*

Best performance of G7 economies

Markets: (Data compiled by The Outsourced Marketing Department)

Geopolitical events continue to hang over the equity markets, with continuing bloodshed in the Ukraine invoking punitive economic sanctions against Russia, massive loss of life in the Gaza Strip and Argentina defaulting on its national debt on the last day of the month.

In the UK the FTSE100 struggled to make any ground, closing July at 6,730.1, down a marginal 0.2% on the month. The wider FTSE250 fared worse, losing 1.45% at 15,495.64 and the AIM market compounding the losses at 2.14% to finish at 768.56.

The USA markets followed suit, as the Dow Jones index lost 1.56% of value ending the month at 16,563.3, and the technical stocks orientated Nasdaq also losing 0.87% to close at 4,369.77.

There was no respite in Europe either, as the Eurostoxx50 headed south, finishing July at 3,115.51, down 3.5% on the month.

In Japan, however, we saw a reverse of fortunes with the Nikkei 225 managing to gain 3.03% to finish at 15,620.77.

On the foreign exchange markets, UK sterling continued to be in demand, despite the fear of currency flight by Russian oligarchs, as a result of threatened sanctions. Against the US Dollar it closed at $1.68, off 1.75% on the month but up 0.8% against the Euro at €1.26. The Euro itself lost 2.19% against the US Dollar, closing July at $1.34.

Surprisingly, despite the global unrest, the price of oil remained subdued; with the benchmark Brent Crude price falling just short of 6% lower at $106.02 a barrel.

Likewise gold, the usual safe-haven asset in times of unrest, fell by 3.07% to close out July at $1,284.92 a troy ounce.

Political unrest hangs over the markets

What is normal?

Mark Carney, the Governor of the Bank of England (BoE), has told the BBC that the timing of any interest rate rise is not as important as the average level at which rates will stabilise in the long-term.

In his opinion the *"new normal"* level of interest rates will be 2.5% and a higher level of (say) 5% is unlikely in the medium term. He was also clear to state that any such increase in interest rates would be far more gradual than was the case in the past.

He said: *"What I am telling you is that the old normal is not the new normal."*

His reasoning behind this statement was that in the current economic environment, any upward rate movement would have a far greater impact on household spending and that given the debt levels currently held by consumers and the fundamentally changed financial system now in place, any increase in interest rates above 2.5% was virtually impossible.

Expanding on his topic, Mark Carney went on to add: *"The big picture is not whether the bank rate goes from 0.5% to slightly above the lowest ever level.*

"That is not the big picture, the big picture is where interest rates go in the medium term, because if I am taking out a mortgage… and if I am thinking of investing in a new plant, if I'm thinking about taking on new people, that's what I care about.

New normal is 2.5%

"The guidance we are giving is…the time will come to raise interest rates…but when we raise interest rates we expect to do so in a gradual and limited fashion."

The BoE has also announced that it wishes to cap more risky mortgages and plans to limit lenders to only allowing 15% of their residential mortgages to be offered to high loan-to-income applicants.

Six-year low for unemployment

Good news was released in July as unemployment in the UK has again fallen in the three months to May, and is now sitting at a six-year low.

According to the Office for National Statistics (ONS), unemployment fell by 121,000 to 2.1 million during that period. The rate now stands at 6.5%, down from the previous level of 6.6%. The annual fall in unemployment has now reached 383,000.

Those claiming the Jobseeker's Allowance - those seeking work or claiming benefits because they are not in employment - also fell to 1.04 million, which is a drop of 36,300 people over the previous reporting period and 419,000 lower than the same time last year.

This data reflects the fact that now, 78% of men and 68% of women are in work – an employment rate of 73.1%. This means that there are now 30.64 million people in work, which are 254,000 more than the previous data and 929,000 more than a year earlier.

At the same time, from March to May 2014 there were 8.78 million people aged between 16 and 64 years old, out of work or not actively seeking or available to work.

David Cameron, the Prime Minister, commenting on these latest findings was quoted as saying: *"Today's figures show more people have the security of a job than ever before. Full employment is a key aim of our long-term economic plan."*

Unfortunately, average wage growth, as reported by the ONS, has been steadily declining since the first quarter of 2014 and (including bonuses) remains stubbornly low at only 0.3% higher than a year earlier and pay excluding bonuses is up 0.7%, both well below the latest inflation rate of 1.9%.