Monthly
Economic Review

Provident Solutions
Wealth Creation & Wealth Management
Financial Lifestyle Planners

Economic review of: June 2012

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

Chancellor Merkel blinks

At last the eurozone managed to agree positive steps to help safeguard the common currency, with agreement at the Brussels summit to directly recapitalise Spanish banks, without these funds being counted as sovereign debt . The official statement coming out of the summit stated: *"It is imperative to break the vicious circle between banks and sovereigns."*

Agreement found in Brussels

Whilst politically difficult for German Chancellor, Angela Merkel, she did manage to agree that the European Central Bank (ECB) will have new powers to regulate eurozone banks. These powers represent a first step towards the banking union that Germany had been calling for. At the same time the summit agreed a €120bn growth fund and the start of negotiations for long-term economic and fiscal co-operation.

Under this agreement Spanish banks will be offered €100bn (£80.7bn) in additional funding. These funds will initially be drawn from the European Financial Stability Fund (EFSF) and then from the European Stability Mechanism (ESM), the successor to the EFSF.

Importantly for the global markets, Italian banks will also be eligible for similar support, if needed. The technocratic Prime Minister of Italy, Mario Monti, was quoted as saying: *"Italy does not plan to activate the mechanism for now, but I do not exclude anything for the future."*

Again pleasing the bond markets in particular, these bail-out funds will not subordinate existing debt. This had become a major worry to investors in European sovereign debt, and should result in yields dropping from their current unsustainable level.

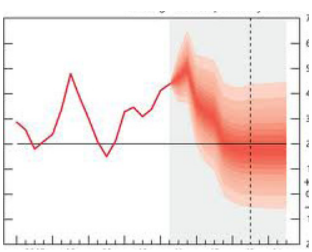
The immediate reaction in the bond markets was to see the yield on the benchmark 10-year Spanish bonds drop to 6.5%. Whilst welcome at below the previous 7% level, this is still an unsustainable rate in the medium term.

Inflation drops again for third month in a row

For the third month in a row the UK inflation rate has dropped. The Office for National Statistics (ONS) reports that the Consumer Prices Index (CPI) measure fell to 2.8% in May from the 3% reported in April.

At the same time they reported that the Retail Prices Index (RPI) measure also fell to 3.1% from the previously reported 3.5%.

These figures reflect a two-and-a-half year low for inflation, mainly due to lower food and fuel prices.



CPI and RPI drops

Commenting on the figures the Treasury stated: *"Inflation is out of the Open Letter territory for the second month in a row, which is good news and is providing some welcome relief for family budgets."*

Main factors behind these reductions were a fall in the price of fruit, particularly bananas, nectarines, peaches, and grapes, together with a reduction in the prices of soft drinks (including mineral water) and vegetables.

Given that the CPI was at 5.2% back in September 2011, these latest figures are a good sign. Pundits cite the reasons for this reduction as the lessening impact of the 2011 VAT rises and a reduction in commodity, food and energy prices.

Whilst welcome news, most economists were surprised by the drop, as they were projecting an unchanged figure for this month. Having said that, they also commented that, in the short term, they expect inflation to fall further.

Although on a cautionary note, the Bank of England also commented that it felt that the CPI inflation figure in the UK will remain above 2% *"for the next year or so."*

The factors behind this statement is their forecast of a possible increase in travel costs, with air fares rising 1.4% in May, against an 11.1% drop last year and sea fares rising 2.6% in May, against a 14.7% fall last year.

As discussed in the accompanying article, this drop in the underlying inflation rate increases the window of opportunity for the Bank of England to reintroduce another round of Quantitative Easing of between £25b and £50b to further boost the economy and - following recent comments from the International Monetary Fund (IMF) - they may also see fit to reduce the base lending rate by 0.25% to an historic low of 0.25%.

If both of these options are taken up, a major fillip to the economy will be offered and, providing the banks use these levers to increase their corporate lending, economic momentum should be invigorated.

QE3 - Will the Bank of England strike again?

With the very fragile economy continuing to show signs of further weakness and the eurozone debt crisis continuing unabated, the Bank of England's Monetary Policy Committee (MPC) very nearly voted in favour of adding an additional £50billion of Quantitative Easing (QE) to the already committed £325billion. The minutes of their June meeting showed that 4 members voted in favour of this (with one member voting for a smaller £25billion), which is only one short of the majority needed to approve the action.

Their prognosis was that the risks to the UK economy had risen since their last month's meeting, particularly from the eurozone. The minutes stated:

"The likelihood of a disorderly outcome looked to have increased, and that could, if it crystalised, have a significant effect on global demand and the

Will they print money again?

stability of the banking system, including in the United Kingdom."

QE is a method of electronically 'printing money' which is a technical device used to boost the money supply and, hopefully, drive economic activity. The Bank of England buys UK Gilts and other categories of assets with this 'new' money. This increase in the money supply has several effects, namely to reduce the value of currency (sterling), increase the value of the assets purchased and lower long-term interest rates, thus encouraging additional borrowing and investment.

It is therefore incumbent on the banks to lend these additional funds to businesses in need of working capital, but this has not always proved to be the case.

A counterpoint to these effects is that many economists believe the QE process leads to an increase in inflationary pressure.

However, with the UK inflation rate dropping to 2.8% (its lowest level for 30 months) in May the Bank of England may be minded to go ahead with additional QE.

The minutes endorsed this possibility by stating:

"On balance, most members judged that some further economic stimulus was either warranted immediately or would probably become warranted in order to meet the inflation target."

We shall have to wait and see for their further deliberations.

Markets: (Data compiled by The Outsourced Marketing Department)

At the eleventh hour Germany's Chancellor, Angela Merkel blinked and the eurozone finally agreed to allow the permanent bail-out fund of the European Stability Mechanism (ESM) to offer financial assistance to eurozone banks without onerous political concessions. This action was a start towards divorcing the pernicious link between bank debt and sovereign debt. The equity markets reacted euphorically with the Greek, Italian, and Spanish bourses appreciating dramatically, together with the French, German and Swedish indexes. Overall the Eurostoxx 50 ended at 2,264.72 up 6.88% on the month.

Markets rebound at end

Here in the UK the FTSE 100 rose by 4.98% on the month to 5,571.10, thanks to this late rally on Friday the 29th. However, it now sits 14.34% below its long-term trend; whilst the FTSE250 also appreciated 3.66% on the month finishing at 10,932.13. Over the pond the Dow Jones index reflected more positive political signals and closed at 12,880.09 which represented a 3.93% gain for the month.

A similar sentiment was seen in Japan, with the Nikkei225 closing up 5.43% on the month at 9,006.78.

Given the positive signals coming out of the eurozone, the Euro appreciated against the US dollar and British pound, showing its best performance for 8 months. It closed at €1.57 against the dollar and €1.24 against sterling. Against the US dollar sterling appreciated slightly to end the month at $1.57 up 1.95% on the month.

Gold remained within a narrow trading range closing the month on $1,592.81, up a modest 2.24% from May, but this still represented a 6.3% increase over the past twelve months.

Oil declined to $97.80 for Brent Crude, a welcome drop of 4% since last reported. This reflects the general global economic slowdown and anticipates a reduced demand for the commodity in the short term.

Good news on the jobs front

The Office for National Statistics (ONS) announced in mid-June that UK unemployment had dropped by 51,000 to 2.61 million in the three months to April. This leaves the jobless rate at 8.2%.

Of this 51,000 the majority were male, as female unemployment only dropped by 1,000, but there were decreases of unemployment across all age groups (other than the over-65's), with youth unemployment finally falling by 29,000. However, this group still represent just over 1 million people.

Unemployment falls again

Employment in the private sector increased by 205,000 to 23.38 million, whilst employment in the public sector fell by 39,000 to 5.9 million. This last figure represents the lowest number since March 2003. In total there were 29.28 million in employment, which is an increase of 166,000 on the last quarter

Their accompanying report stated that overall the UK unemployment level was *"showing some improvement."* This is despite the fact that the number of those claiming Jobseeker's Allowance increased in May by 8,100, which makes a total of 1.6 million people.

They went on to say that whilst in previous months any increase in employment was due to part-time workers, this month's figures saw an averaging out across part-time and full-time workers.

Chris Grayling, the Employment Minister commenting on these figures stated:

"This time we are seeing a very healthy increase in full-time jobs and that's clearly very welcome..."Any fall in unemployment is very welcome, but I remain cautious over the next few months, given the continuing economic challenges we face."

At the same time Brendan Barber, the TUC's General Secretary said:

"some long overdue good news." But he went on to add that he still had "real concerns" over the sustainability of the recovery shown.

CBI sees UK factory output increasing

The Confederation of British Industry (CBI) has just released its regular survey of manufacturers which has offered a fillip to the sector. It states that 17% of manufacturers reported an increase in their order books and that they were above *"normal levels"* for June. The counterpoint to this was that 28% said their order books were below these levels.

Manufacturers show optimism

Whilst this is seemingly a negative outcome, the net balance of -11% is a marked improvement from the previously reported data for May which represented a -17% figure.

At the same time those manufacturers canvassed, reported that they expect their output levels to improve further over the next quarter, against those reporting a negative prospect, represented a +7% net balance for June. This same measure was a -3% figure in May.

With the political and fiscal troubles in the eurozone still hanging over the export markets, it is good news to see that UK manufacturers are reporting a modest improvement in both their domestic and export market activity.

Commenting on this report, The CBI's Chief Economic Adviser, Ian McCafferty was quoted as saying: *"As a result, firms are expecting output to pick up over the next quarter, although the pace of growth is still expected to be somewhat lower than earlier in the year."*

Reinforcing this sentiment, Blerina Urici of Barclays Capital, whilst anticipating a drop-off in industrial output in Q2, primarily as a result of weakness in the sector and the additional bank holidays in celebration of the Queen's Jubilee, went on to add: *"We then expect a strong rebound in the third quarter and for growth to resume at a more stable pace from the end of the year."*

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