Monthly

Economic Review

Provident Solutions
Wealth Creation & Wealth Management
Financial Lifestyle Planners

Economic review of: March 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

Steady as she goes

The Budget brought few surprises - other than cancellation of the fuel duty escalator and an immediate 1p cut in duty. This was to be expected because it is the first Budget given by any Chancellor that tends to be most significant; subsequent ones either consolidate or correct previous versions.

This month saw a clear consolidation of what had gone before with the intention of ensuring that government borrowing was brought under control, rather than seeking to provide populist give-aways.

The main news was that GDP is likely to grow more slowly than expected during 2011 (1.7% compared with earlier estimates of 2.1%) and that borrowing is likely to be slightly higher than expected. Keeping borrowing within manageable limits is essential, because only thus can the interest rate we have to pay on sovereign debt remain low. The market interest rates we pay have fallen to 3.6%; by contrast, those paid by Greece are 12.5%, Ireland almost 10%, and Portugal 7%. If our interest repayments were to be forced up, this would dramatically reduce the rate of economic recovery, as the budget deficit would start to rise again without even more drastic – and potentially recession causing – action.

There is no room for complacency whatever happens, because one of the ratings agencies has already pointed out that slower growth could reduce government revenue, making it more difficult to pay off borrowings. This would threaten our “Triple-A” rating, which would also force up our sovereign debt interest rates.

The biggest threat to recovery?

Are we using too much?

The rising cost of oil could be seen as one of the greatest threats to recovery, largely because it is something over which we have no control – and partly also because it is subject to the vagaries of speculators.

Tinkering at the edges of taxation is unlikely to have a significant impact; the fact is that not just families but businesses are hit every time fuel prices rise and this contributes towards higher inflation. What we need to do is find an alternative to using so much oil. This falls into two major areas; travel and energy. In view of recent events in Japan, increased use of nuclear power is hardly likely to gain favour for a long time, but there are other alternative forms of energy, such as wind-power and wave-power; both of which we have plenty, being an island nation!

It is, however, transport where we could achieve ‘quick fixes’ because lead times for developing new power stations are long, whereas changing driving habits can be done instantly. Where hauliers are able to avoid travelling at peak times, the saving in diesel can be massive; the same applies to car drivers. High speeds can dramatically increase fuel consumption, but driving at a constant speed can make good much of the damage.

It is unfortunate that we no longer have a railway network that serves more remote parts of the country, because that could make many forms of personal and business transport redundant; but just because Dr (later Lord) Beeching cut the railways by a third in the 1960s, this does not mean that alternatives could not now be sought. Appropriate spending on new infrastructure could actually help the economy, if businesses could be incentivised to invest, rather than relying on state spending. After all, that is how we got the railway system in the first place.

Inflation and interest rates

Is it worth carrying coins at all?

Inflation continues to be a major concern to everyone - except, perhaps, the Bank of England’s Monetary Policy Committee, which again voted 6-3 against an increase in base rate. Of the minority voters, one wanted the rate to double to 1%, while two preferred a quarter-point rise.

In February, the Consumer Prices Index – which is going to be increasingly important to us all, because most tax allowances will be linked to it by default in future – was well above target at an annual rate of 4.4%; this may not sound much, but it is one-tenth up on January. The Retail Prices Index, which was previously the favoured benchmark, is even worse at an annual rate of 5.5%.

Inflation was partly driven by a 7.7% increase in transport costs over the past year, as well as a 6.3% increase in food costs. The cost of entertainment also rose, with alcohol and tobacco up 6.7% and restaurant and hotel prices up 4.5%, year-on-year.

Interest rates round the world		
UK	0.50%	No change for 24 months
USA	0.25%	No change for 27 months
Europe	1.00%	No change for 22 months
Japan	0.10%	No change for 27 months

One impact of inflation has been to conceal a reduction in the volume of consumer spending. Retail sales continued to grow, according to the Bank of England Agents' Summary for March, but not in real terms.

There is, however, evidence of rapid growth in exports, largely due to increased demand from emerging markets and Germany and some other parts of Europe.

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

March could be described as "a game of two halves" with stockmarkets generally falling during the first half, when fears over Libya caused a tumble compounded by the earthquake and tsunami in Japan, that was amongst the worst experienced recently – and had a massive economic effect, not to mention the cost to the global insurance industry. However, from mid-month, jitters appear to have abated as matters in the Far East became clearer and Japan started to get its nuclear power plants under some sort of control and the rebels in Libya appeared for a while to be gaining ground. Unfortunately, March went out on a downbeat note with the FTSE100 ending the month -1.42% down; just 4% higher than a year ago. The Nikkei225 lost -9.72% of its value during the month.

Japan's traditional tranquillity disturbed

The Dow Jones, however, managed to grow by 0.76% during March, putting it some 13.5% higher than a year ago. Sterling lost -1.25% against the US dollar and -3.82% against the euro during March, in the latter case, partly as a result of increased confidence in Europe after hints of a possible interest rate rise during April. Oil continued its seemingly inexorable rise, adding 2.65% during March to end at US$115.13 per barrel for Brent Crude 1-month futures.

Public sector pensions

Lord Hutton had been invited by the government to report on the future of public sector pensions in view of the 'black hole' in its finances. His report contains a number of recommendations aimed at reducing the impact that the open-ended commitment represented by defined benefit pensions has on taxpayers.

Walking a tightrope between taxpayers' and employees' interests

However, he also considered what might be fair to those working within the public sector.

In addition to recommending higher retirement ages for those concerned, he also suggested that members should pay a larger percentage of their income towards the cost of providing these gold-plated pensions.

The largest change, however, is the recommendation that future benefits should be accrued on a career-average basis. This can actually favour the lower earner, compared with high fliers, as it looks at earnings for each year worked, and then re-values them in line with inflation (presumably this will be CPI, limited to 5% a year) until retirement. Clearly, anyone whose earnings are relatively uniform will do relatively better than someone whose income increases dramatically in the run-up to retirement.

The overall effect of this should be to reduce the massive deficit that we are building up for future generations of taxpayers.

Employment

One of the most important factors in economic recovery will be whether the private sector is able to make up for the inevitable job losses in the public sector associated with the need to cut government expenditure.

Yes, but what comes after study?

The balance is important, because every private sector job created represents income for the government in terms of tax and National Insurance contributions; whereas each public sector job cut saves salaries, employment and pension costs. But more than this, private sector jobs can generate wealth, unlike the public sector. Of course, a certain level of public sector is essential to provide the services that keep the country – especially vulnerable groups – going.

ONS figures show that unemployment rose by 27,000 during the last quarter of 2010, although the number is still only just over 2.5 million, which is far better than many feared at the start of the recession. Part of this is probably due to the resilience of the private sector, where many firms appear to have become more efficient and employees have agreed to short working, pay freezes and even reductions in order to avoid layoffs.

Most worrying, however, is that the number of young people out of work is rising, with 30,000 more 16-to-24 year-olds out of work by the end of the year. 974,000 is the highest level of youth unemployment since records began in 1992 and represents a massive loss to the future economy, should these become long-term unemployed.

Issued by: **Provident Solutions Ltd**
Kingston House, Meadow Hill, Great Glen, Leicester LE8 9FX
Telephone: 0116 2592371 - Fax: 0871 750 2621
Email: enquiries@providentsolutions.co.uk - Website: www.providentsolutions.co.uk