Monthly

Economic Review

Provident Solutions
Wealth Creation & Wealth Management
Financial Lifestyle Planners

Economic review of: March 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

Third Budget from the Coalition Government

With the austerity measures still firmly in place, the third Budget from George Osborne and the coalition Government offered few surprises and very little largesse.

A fiscally neutral Budget

As expected, he intends to crack down on "aggressive tax avoidance" measures, with stamp duty rising to 7% on £2m+ houses and the introduction of a punitive 15% for such properties bought through 'non natural' purchasers - that is companies and off-shore structures/trusts to you and me.

He also made significant changes to the personal tax regime, with a broadening and flattening of the bands. The top 50% tax band, for those earning £150K + per year, was reduced to 45%, to take affect from April 2013, whilst at the other end of the pay scale the personal allowance was increased to £9,205 from April 2013, with a view to increasing this further to £10,000 within a few years.

In an attempt to boost economic growth, he turned his attention to businesses, reducing corporation tax to 24% (down 2% rather than the expected 1%) from April 2012 and by a further 1% in both 2013 and 2014 as planned. He announced his intention to hopefully, reduce this down to 20% in the near future, which will make UK Ltd the cheapest place to do business in Europe.

The limit for Enterprise Management Incentives was also increased to £250,000 as of April 2012 and there was an increase in R&D allowances for large businesses.

Venture Capital Trusts benefited from the fact that the annual amount a company can raise through this vehicle will be raised from £2m to £5m, albeit below the £10m that had been intended until Brussels intervened.

The energy sector benefited from increased decommissioning tax relief for oil rigs, and the promise of a £3bn new field allowance for large and deep fields that open up west of the Shetland Islands, the last exploration area to be commercially exploited.

On the personal front, controversially, but well forecast, he has withdrawn child benefit from families where one member has an income over £50K pa, and introduced a sliding scale of benefit withdrawal until such income reaches £60K pa, at which point child benefit will be lost entirely.

At the same time, old age pensioners (or those about to become one) were dealt a body blow with the phasing out of age-related income tax allowances for the over 65's, until future increases in the basic allowance catches this up. This was tempered only slightly by the inflation linked increase of 5.2% to their state pension moving forward.

The Chancellor's forecasts for the greater economy were: GDP growth to rise to 0.8% in 2012, to 2% in 2013, 2.7% in 2014 and by 2015 to reach 3%.

Record low rates tempt Treasury to issue 100-Year Gilts

Taking advantage of the historically low interest rates and the UK's current standing as a global safe-haven for capital, the UK Treasury is canvassing the market to gauge the appetite for a super-long 100 year (or even a perpetual) gilt bond.

Record low interest rates

If successful, this would enable the Government to lock in the current very low rates for decades to come, greatly reducing the cost of the country's borrowings going forward into new generations. Treasury officials were reported as saying the plan would be akin to the country embarking on a low-rate fixed-term mortgage and their official figures show that such low-cost borrowing in the super-long term would be able save the country £20bn in debt interest over just the next five years alone, which equates to £1,000 for every UK household.

Historically, long-dated gilts have matured after 30 years, so this would be a major departure for the Debt Management Office. There are, however, several perpetual gilts still in existence, with £2bn of debt attached to them. The last of these was the infamous 3.5% War Stock, which at today's prices offers an investor a 3.9% return.

Currently among the largest purchasers of UK Gilts are the pension funds, who require a guaranteed rate of return over long periods of time. Typically though they have sought index-linked issues with maturities in the 30, 40 and 50 year range. There is some doubt as to whether a 100-year or longer issue would suit their long-term commitments.

Joanne Segars, who is Chief Executive of the National Association of Pension Funds (NAPF) and represents this group of potential buyers, was quoted as saying: *"A 100-year bond would be too long for most pension funds, and we don't think that many would buy them."*

She went on to say: *"Most final-salary pension schemes are now closed to new joiners and are becoming more mature. Their liabilities are long-term, but not that long-term".*

Markets: (Data compiled by The Outsourced Marketing Department)

Whilst March saw the FTSE100 close marginally down 1.75% on the previous month at 5,768.5, the overall bullish impetus of the first quarter of 2012 continued, seeing the main index close up 3.5% since the start of the year, which resulted in about two thirds of 2011's losses being recouped. Both the FTSE250 and AIM markets followed suit with strong performances; registering gains of

Positive territory regained

14.2% and 14.7% over the quarter respectively to sit at 11,538.88 and 795.06.

Positive economic data from the USA, including better than expected consumer spending and additional liquidity measures from the Fed, allowed the Dow Jones to finish the month and quarter on 13,214.04 for a 3.7% gain on the previous month and an 8.1% gain since the year end.

The NASDAQ showed an even stronger performance, reflecting the high-tech developments, closing the month up 4.2% at 3,091.57, which represents a gain over the quarter of 486.4 points or 18.7%.

This global optimism was reflected in the Eurostoxx 50, closing the month down a modest 1.38% at 2,477.28, which none the less represents a gain over the quarter of 6.9% and in Japan the Nikkei 225 saw a strong monthly performance rising 3.71% to 10,083.56. This was an impressive 19.2% gain for the quarter.

Oil continued to be watched closely, with the political stand-off continuing between Iran and the West. Brent crude ended the month at $122.8 a barrel, which is a modest rise of 1.09% on the month, but this could move higher in the coming months if the tension increases in the region.

The precious metal gold had a relatively quiet month, finishing the quarter on $1,667.04 an ounce, as investor attention seemed to concentrate on the equity and risk markets.

The FX markets remained flat, following the Greek bailout, which allowed the Euro to pause for breath. The €/$ rate closed March at $1.34, registering a very modest gain of 0.75% and the £/€ rate at €1.20, again registering a modest gain of 0.84%. Meanwhile the green back remained steady at $1.60 to the British pound, little changed on the month, but up 2.5% on the quarter.

Has the UK economy turned the corner?

There are many signs that in Q1 and into Q2 of 2012 we are seeing the UK economy turn positive, at last.

Is the UK economy on the way up?

In the UK service sector, there was a positive improvement in the purchasing managers' index (as reported in detail last month) and public sector borrowing is estimated to come in at about £7bn below the Office for Budget Responsibility's (OBRs) forecast for the financial year 2011/12.

Again as forecast, UK inflation is on a downward trend and is set to continue in that direction, heading for the Bank of England's 2% target soon. This will help the battered consumer and help lift retail sales in the short and medium term.

Private company finances appear to be in fine fettle, with almost record cash balances being retained on their balance sheets. This implied liquidity should stand the private commercial sector in a strong position to maximise any benefit seen in any upturn in the market and allow immediate investment to prime the markets further, when needed.

By the – eventually - agreed bail-out by the Troika of the European Union, The European Central Bank (ECB) and the International Monetary Fund; the 'Sword of Damocles', in the shape of Greek (and possibly other Eurozone countries') default has been temporarily removed from the equation, which in turn has brought a renewed optimism to the global and hence UK markets.

In addition to this bail-out, the ECB has injected a further €1 trillion of cheap (1%) funding into the Eurozone banking sector. Eagerly taken up by most market players, this has further reduced any fear of a secondary credit crunch in the region's banks and consequently boosted market sentiment.

This is reflected in the fact that almost all global equity markets have seen a sustained rally in Q1 2012. Details of this can be seen in our 'Markets' article.

Reflecting the global nature of any market sentiment, the world's primary economy, the USA, has consistently reported a bullish trend, particularly in its job data, with more people entering the jobs market there to help drive the global economy forward.

So overall a very positive start to the year in UK terms, but some caution should be maintained. Macro-economic issues are still capable of throwing a preverbal spanner in the works, however.

Areas to be carefully assessed are the oil supply; with Brent Crude prices at $122.8 a barrel (though still short of the record dollar-terms high of $147) and with Nigeria and Iran threatening world supplies in the short term, this could unhinge the existing momentum. Also a perceived slowing of the Indian and giant Chinese economies, and continuing austerity measures being taken to dampen consumer demand in the economies of Greece, Spain, Portugal and Italy, should be monitored closely.

UK Chancellor, George Osborne, in his 2012 Budget (see Budget report) has endorsed this cautiously optimistic view by reporting the OBR's figures for GDP growth in the UK economy of 0.8% in 2012, 2% in 2013, 2.7% for 2014 and 3% in 2015.

These figures therefore reflect a modestly positive outlook for the UK economy moving into the next few years.

Public sector pay outstrips private sector

Pay-gap increase to 9%

Public sector pay is outstripping private sector pay by 9%, which represents a 10-year high point. In a complicated calculation, the Office for National Statistics (ONS) states that those public-sector workers were paid an average of between 7.7% - 8.7% more than those in the privatesector. This compares to a figure of 5.3% reported in 2007, the year before our current financial crisis.

To make sure that like was being compared with like, the ONS figures have assumed that bank workers, unilaterally recruited into to the publicsector via the bank bail-outs of the likes of the Royal Bank of Scotland and Lloyds Banking Group, were considered to be private-sector employees until 2011. If that had not been the case then the figures would have reflected an even higher margin of 9.3%.

Factors influencing these statistics were cited as the publicsector having more older workers, where salaries tend to increase with service and that public-sector workers were more likely to be highly skilled (as lower-skilled jobs tended to be outsourced to the privatesector) and hence more likely to be graduates or professionally qualified. At the same time, the ONS stated that within the privatesector workers were more likely to be offered additional benefits such as health insurance, company cars and health club subscriptions.

As a caveat, both the ONS and unions commented that direct comparisons were hard to assess and that the task was not "straightforward".

Unison, the public-sector union, argued that the report "masked the reality" of low pay and the current pay freeze imposed on the public-sector workers.

In response, the CBI's Director for Employment, Neil Carberry, commented on these findings: *"These average pay figures do not make direct comparisons between specific job salaries in each sector. Nevertheless, it is clear that public-sector pay is still considerably higher than pay in the private sector."*

He went on to say: *"We need to ensure that public-sector salaries reflect local labour market conditions, by putting pay decisions into the hands of individual employers at the local level."*

Again these comments reflect statements made by the Chancellor in his Budget speech.

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