Monthly

Economic Review

Economic review of: **May 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

The Chancellor needs to balance cuts with protecting growth

Debate over the level of spending cuts is polarising with the left saying that the Chancellor is cutting too far too fast, while the right says he is not doing anything like enough to 'roll back the state' à la Thatcher.

Data quoted in the Sunday Times (29/5) suggests that, while the economy has 'flat-lined' over the past six months, government spending rose by 1% during 1Q11 after growing 0.4% in 4Q10; public spending contributed two-fifths of first quarter GDP growth and spending was 5% up in cash terms. The VAT increase may have weakened consumer spending during the first three months of this year, but this effect is unlikely to continue to impact as people become accustomed to higher prices. It should not, therefore, combine with spending cuts to destroy the economy, as some politicians would have us believe.

Importantly, the OECD now argues that the current fiscal consolidation strikes the right balance and should continue in line with the medium-term plan to eliminate the deficit. Its chief economist, however, says that the cuts should be slowed if growth is weak; by this he is probably referring to the fact that slow growth reduces tax revenue, while increasing spending on unemployment benefits. This means that the Chancellor needs to exercise caution if growth rates fall further and be prepared to backtrack on cuts.

In any event, the OECD appears to feel that, at about 3%, our projected deficit cuts by 2012 (as a proportion of GDP) are not out of line with those in France and Italy – or for that matter Germany (2.5%). By comparison, cuts in Ireland, Portugal and Spain range from about 4% of GDP up to 12% of GDP in Greece.

Over the longer term, however, the IMF suggests that our proposed spending cuts and tax increases up to 2015, at 8% of GDP, are significantly higher than many of our leading competitors. If it works, ours should become a very strong economy indeed.

How is the UK economy performing?

The Old Lady of Threadneedle Street is not hiding the challenges we face

According to data from the Bank of England Agents' Summary for May, annual growth in retail sales continues to slow. This is perhaps predictable, as consumers are cautious over making larger purchases while focusing on essentials such as food, energy and other unavoidable expenses. Uncertainty over employment prospects could well be one of the main factors, although continued lack of confidence in the housing market could also be a factor. People tend to spend more when they feel better off because their houses are rising in value – a factor highlighted in the summary to account for softening activity in the housing market. Conversely, data from Rightmove appears to suggest that sellers' asking prices hit a three-year high in May – although the estate agency organisation agrees that the number of new instructions has fallen.

The Summary does, however, point to a growth in demand for business services, albeit modestly, while investment intentions also point to moderate growth. Interestingly, manufacturing output for the domestic market is growing more slowly than for exports, which can be seen as a positive indicator for our balance of trade. Unfortunately, raw materials costs are rising due to higher world demand and supply shortages; this makes imported finished goods more expensive.

Employment intentions point to continued growth, but those contributing to the Summary indicate that future plans have been revised downwards, partly because labour costs are rising (at moderate pace).

Inflation and interest rates

The consumer prices index jumped to an annual rate of 4.5% in April – up from 4% in March and higher than market expectations of 4.2%. This continues to make matters difficult for the Bank of England's Monetary Policy Committee, which is targeted to keep CPI inflation within one percentage point of 2%.

The normal response to higher inflation is, of course, to increase interest rates in order to reduce demand. This assumes that the inflation is domestic and not caused by international conditions – or tax increases – but with the economy facing a difficult short-term future as the imbalance of government spending to its income needs to be reduced, an immediate increase in interest rates does not appear to be on the cards.

Inflation continues to be a threat

Interest rates round the world		
UK	0.50%	No change for 26 months
USA	0.25%	No change for 29 months
Europe	1.25%	No change for 1 month
Japan	0.10%	No change for 29 months

In his final MPC vote, Dr Andrew Sentance voted for a half percent increase, while Spencer Dale and Martin Weale voted for a 0.25% hike. However, six members voted against a change. Adam Posen was the only Committee member to vote to increase the size of the asset purchase programme by £50bn to £250bn.

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

Perhaps predictably, with some investors apparently still believing in the old adage "sell in May and go away; don't come back 'til St Leger Day", most of the markets we track fell during the month, with the FTSE100 losing -1.32%, thus falling below what increasingly appears to be a 'magic' 6,000 level. Having said this, it is still some 15% higher than a year ago – and some commentators still believe that there is scope for the index to nudge 7,000 by the end of 2011. Actually, the monthly fall was probably justified by some poor jobs data from the US and at least temporary concerns over the debt crisis in Greece. The mid-cap FTSE250 actually gained 0.39% in May and is therefore 25% higher than this time last year.

May - still a time for traditional activities?

Elsewhere, the Dow Jones lost -1.88% but is now some 24% up over twelve months. Worst performer during May was the Eurostoxx50, which fell by -4.96% to end 9.6% higher than in May 2010; even the Japanese Nikkei225 only lost -2.84% during May.

Some good news was that oil lost -8.9% over the month to end at $114.68 a barrel for Brent Crude 1-month futures. This is still, however, 55% higher than a year ago. Interestingly, gold, which lost -1.74% during May to end at $1,532.01 per Troy ounce is 'matching' the FTSE250 and Dow Jones with growth of around a quarter over the past twelve months.

The rain in Spain …

Barclays Bank is apparently considering investing in some of the Spanish regional banks (cajas) that make up about half that country's retail banking sector. These are the institutions that lent €500 billion to fuel the Spanish property boom that subsequently fell apart so spectacularly. Clearly, if Barclays proceeds, it will be looking for some guarantees from the Spanish government – particularly since the cajas have also lent heavily to regional and local authorities, fuelling their ballooning deficits.

Will the sun shine in Spain for Barclays?

… and heat in Greece

Meanwhile, there is still opposition to austerity measures in Greece, where Prime Minister George Papandreou is trying to put together a package that will unlock much needed EU and IMF funding. Opposition leaders would prefer to see the terms of the bailout renegotiated. Whatever we may think about our own austerity measures, at least international markets appear confident that the UK is moving in the right direction, if credit ratings are any guide.

Employment

According to the Office for National Statistics, the rate of employment in March stood at 70.7%, which was 0.2% higher than at the end of the last quarter of 2010; the number of us working increased by 118,000 on the quarter (which is 416,000 more than at this time last year) to reach 29.24m. However, the number of employed people was still 332,000 lower than the pre-recession peak of 29.57m recorded for the three months to May 2008. The quarterly increase in employment was mainly driven by full-time employment, which increased by 94,000 on the quarter to reach 21.30m.

The young must be allowed to blossom

Worryingly, unemployment among 16 to 24-year-olds was recorded at 935,000, which means that 1 in 5 young people are out of work. This should be a matter of concern to everyone, especially should the apparently widespread threefold hike in university tuition fees discourage more young people from entering higher education. We simply cannot afford to have such a high proportion of young people facing a future devoid of the meaning that contributing to society could offer them.

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