Monthly

Economic Review

Provident Solutions

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Financial Lifestyle Planners

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Economic review of: May 2013

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

Bank of England turns bullish on economy

Bank of England Governor Sir Mervyn King, in his last economic growth forecast before retirement in June, turned slightly bullish and predicted that UK Gross Domestic Product (GDP) would grow by 0.5% during the current second quarter of 2013.

0.5% growth predicted for Q2

He said: *"Today's projections are for growth to be a little stronger and inflation a little weaker than we expected three months ago. The economy is likely to see a modest and sustained recovery over the next three years. That's the first time I've been able to say that since before the financial crisis."*

However, there was a caveat, that the recovery would *"remain weak by historical standards."* This reflects Sir Mervyn's further comments that: *"This hasn't been a typical recession and it won't be a typical recovery. Nevertheless, a recovery is in sight."*

Inflation has been stubbornly high – though it eased in April – having remained above its 2% target since 2009, and the BoE believes it will not return to this optimum level until 2015 or later. So, it has held back on its quantitative easing programme, as any expansion of it now could increase inflationary pressure.

Sir Mervyn added: *"Monetary policy alone, however, cannot solve all our problems. There are limits to what can be achieved by general monetary stimulus in any form."*

Commenting on the BoE stance, the Chief Economist of the British Chambers of Commerce, David Kern, said: *"We accept that growth is likely to remain positive, but we believe that the speed of the recovery will be somewhat slower than the Governor indicated.*

"The grim eurozone data also shows that our exporters will face obstacles over the year ahead. We also think that the inflation outlook is slightly worse than the report suggests, and future falls in 2013 and 2014 will not happen as quickly."

European Central Bank cuts rates

In a long-awaited move, the European Central Bank (ECB) finally cut its benchmark interest rate from 0.75% to 0.5%, having had the rate on hold for 10 months despite the worsening economic health of the eurozone member states.

A drive for growth in eurozone

The ECB eventually moved, as manufacturing output shrank in April across the 17-nation bloc, including Germany. Unemployment also reached an all-time high, with inflation at a three-year low. Also, the Purchasing Managers' Index (PMI) for the eurozone fell to 46.7 in April, against 46.8 in March. Even in Germany their PMI fell to 48.1 in April, from 49.

Chris Williamson, Chief Economist at Markit, which collates the PMI data, said: *"There is nothing here to suggest that manufacturing will turn the corner and stabilise any time soon, putting greater onus on policymakers to act quickly to reinvigorate growth."*

However, market reaction to the ECB's move was positive, with the euro strengthening against the US dollar for a time and hope building that the lower interest rates would reduce borrowing costs for the wider economy, thus boosting economic growth.

There have been fears that lower interest rates have not - to date - helped the weaker eurozone countries, such as Greece, Spain, Portugal, Italy and Ireland. Some of these countries, together with France, have called for a relaxation of the austerity measures already put in place, which they believe have stifled growth in their region.

Expressing a sentiment echoed by Italian Prime Minister Enrico Letta and French President Francois Hollande, the European Council President Herman Van Rumpuy called for a strategy that would promote growth and create jobs. He was quoted as saying: *"Taking these measures is more urgent than anything. After three years of fire-fights, patience with austerity is wearing understandably thin."*

Markets: (Data compiled by The Outsourced Marketing Department)

Not quite a steady climb

Having reached impressive levels given the economic backdrop, global equity markets became nervous at times during late May as investors tried to make sense of mixed financial data. The UK stock market saw a correction on 23 May, when the FTSE100 lost 2.1% as it retreated from a 13-year high. It still ended the month up, by 2.4%, at 6,583.1, whilst the FTSE250 closed at 14,350.9, up 2.9%. The AIM market put on 3.3% to finish at 729.9.

In New York, the Dow Jones avoided major gyrations to reach a new high of 15,409.4 on 28 May. Falling back 208 points on the last day, it still ended May ahead 1.9% at 15,115.6. The Nasdaq ended 3.8% higher at 3,455.9. European bourses had bouts of nerves that impacted the Eurostoxx50, but it managed to finish the month some 2.1% to the good at 2,769.64.

Nervousness was most acute in Japan, where a 40% rise in the Nikkei during 2013 had left Tokyo vulnerable to profit-taking and price correction. A one-day fall of 7% exposed the market's fragility, but a modest rally on 31 May helped the battered index end the month at 13,774.5, just 0.6% lower – and still 61% higher than 12 months earlier.

The dollar strengthened on the foreign exchanges, firming 1.5% against the euro, to $1.30, and nearly 2% against sterling, to $1.52. Sterling weakened slightly against the euro, to €1.17. On the oil market, Brent crude spent most of May hovering just above $100 and closed almost 2% down, at $100.39. Gold continued to lose its glitter and, after dipping down near $1,340 mid-month, it ended 5.6% lower, at $1,388.21.

Major power shift in oil production

US swings to exporter

Accelerating production of shale gas and oil in the US has led to a large increase in declared reserves. Shale gas and oil are extracted by 'fracking', where water is blasted at high pressure into shale rock to release deposits trapped within it.

This increase in production will have a profound impact on the US economy, as the country will move from being the world's largest importer of oil to becoming a net exporter and by 2015 will overtake Russia, the world's current largest gas producer.

However, fracking is not without its critics; environmentalists cite issues around excessive water usage, water contamination, the release of methane gas and unwanted seismic activity.

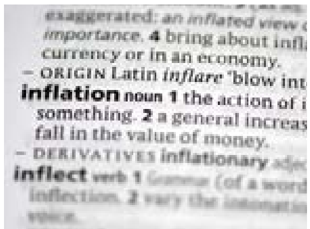
The influential International Energy Agency (IEA) predicts that within five years the USA will account for 30% of new global oil supplies. It also forecasts that they will be "all but self-sufficient" in their energy needs by 2035.

Maria van der Hoeven, Executive Director of the IEA, was quoted as saying: *"North America has set off a supply shock that is sending ripples throughout the world."*

An effect of this will be much slower demand for Middle Eastern and other OPEC oil producers' output and a likely reshaping of the whole energy industry. The global demand for oil is set to rise by 8% and it is anticipated that most of this increase will be met from non-OPEC producers.

From 2012 to 2018 the IEA expects US oil production to grow by 3.9 million barrels per day (bpd) and account for over 60% of predicted growth in non-OPEC production. OPEC, currently accounting for about 35% of global oil output, is still expected to lift production by 1.75 million bpd to 36.75 million bpd, some 750,000 bpd less than a previous IEA forecast.

Double-edged sword as inflation eases



Surprise drop in UK inflation rate

In an announcement that surprised many observers, the Office for National Statistics (ONS) reported that UK inflation, as measured by the Consumer Prices Index (CPI), dipped for the first time since September 2012 to 2.4% in April, down from the 2.8% recorded in March. At the same time, the wider Retail Prices Index (RPI) measure dipped to 2.9% against the 3.3% recorded in March.

Major factors affecting prices in April were the fall of 2.1p per litre in petrol and the 3.9p per litre fall for diesel fuel. Drivers have now seen petrol and diesel prices stabilise at approximately £1.33 and £1.38 per litre, respectively.

However, food prices generally rose, as an effect of the continuing cold weather that has reduced many farmers' yields substantially. The wider picture here shows that food prices have risen by 40% since 2007 and this trend is likely to continue, with added pressure on fruit and vegetable prices generally.

The double-edged sword here is that, given the lower than expected inflation figures, the foreign exchange markets have factored in the point that this will make sterling less attractive, as the Bank of England (BoE) can leave interest rates at their historically low 0.5% and may be more inclined to resume the quantitative easing programme, which currently stands at £375bn.

With the BoE signalling that it is relaxing its stance on inflation, this may well limit the options of the incoming Governor, Mark Carney, who takes up his position this July. His brief is to boost economic growth, whilst at the same time bringing inflation under control. He may well have his work cut out to achieve both those goals under the present circumstances.

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