

Economic review of:

October 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

Recapitalising Europe's banks

At the eleventh hour the European leaders of the Eurozone have finally agreed a three-pronged solution (hopefully) to the on-going debt crisis.



Political consensus wins the day

This political consensus, following weeks of impasse, will embrace a 50% haircut for holders of Greek sovereign debt and at the same time ensure that the banks, who currently hold large amounts of this debt, will be re-capitalised to the tune of €106 billion, to cushion the blow to their top line as a result of any future sovereign default.

The final element of this rescue package is an increase to €1 trillion (£880 billion) for the European Financial Stability Facility (EFSF). However, the exact details of just how the 17 Eurozone countries will raise these sums has not been made clear, with ominous references to possible 'leveraging' of this facility.

Because of this lack of clarity, the immediate effect will be some relief in the market place, however, as witnessed by the upward leap in all the European stock exchanges, but until precise funding details are revealed the same markets will remain extremely cautious for the medium and long-term outlook for the more endangered countries such as Portugal, Italy, Ireland, and Spain.

Meanwhile, Italy has grasped the nettle it seems with their leader Silvio Berlusconi promising to balance their €1.9 trillion debt and implement some of the austerity measures that will be needed to achieve that, a very difficult political call for him to make.

Where the UK sits in this regard remains to be seen and until the funding details of the entire package are revealed

we still need to address our own local bank liquidity issues. The latest, and arguably most robust, round of bank stress tests, initiated by the European Banking Authority, is likely to conclude that two thirds of the 90 banks who have responded so far will fail the test and therefore be obliged to raise fresh capital.

As an example, the investment bank Credit Suisse concludes that a major bank here in the UK, The Royal Bank of Scotland (RBS), may need to raise as much as £16.9bn of fresh capital.

As a result of this, the credit agencies are continuing to downgrade both the UK's major banks, RBS and Lloyds, together with sovereign states credit ratings, with Spain being the latest sovereign victim.

Therefore this agreed major round of new capital raising will need to take place very soon with both the public and sovereign coffers being tapped for large amounts of new money, further reducing the liquidity in the European capital and debt markets.

Leading commentators seem divided on their initial responses to the announcement (on early Thursday morning October 27th) with some reflecting that this 'eurofudge' will fail, whilst George Papandreou, the Greek Prime Minister, was quoted as saying "We can claim that a new day has come for Greece and not only for Greece but also for Europe." M. Sarkozy, the French President, goes even further saying that this Eurozone policy decision will relieve "the whole world."

However, a late spanner was thrown into the equation with the Greek parliament announcing - on the last day of the month - that it will hold a referendum to ask its people if they want to accept the largesse of the Eurozone (and others), and the incumbent austerity measures that will go with it at all.

Only time will tell how, or indeed when, this scenario will end.

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

In an exceptionally volatile market the FTSE100 managed to gain 9% in the month of October, but it was a hectic ride for those brave enough to play, with the index having lurched between inter-day gains of 2.98% on October 28th to intra-day losses of 2.97% on the last day of the trading month.



A helter-skelter month

Up until the last day of the month the global equity markets were looking robust, but Greece's decision late on Monday, October 31st to hold a referendum on the Eurozone's rescue plans caused the positive sentiment to evaporate, literally overnight.

Surprisingly, given this volatility, daily volumes in the FTSE100 remained at a healthy level with an average of 845,000 trades, peaking at 1,454,233 trades on October 27th the night of the Eurozone summit.

With the political (and economic) vacuum relating to the Eurozone debt crisis creating negative investor reactions in the early part of the month the final political consensus, agreed after a marathon all-night summit, calmed those nerves considerably towards the latter part of the month, only for that sentiment to swing down dramatically on the last day of the month. However, the index still managed to recover no less than 469 points overall from the previous month's closing figures.

Long-term trends in the FTSE100 therefore improved to sit 14.27% below that trend, which represents a substantial improvement from the 20.67% shortfall reported last month.

Other major markets followed this European trend with the Dow Jones closing the month 9.5% up at 11,955 whilst the Eurostoxx50 reflected a 9% gain to 2,385 and the Nikkei225 recording a more modest gain on the month of 3% at 8,988.

Overall then global markets recovered from the malaise of last month, but the Eurozone debt crisis still hangs like a sword of Damocles over both the equity and bond markets.

On the commodity front, Oil remained stable with the Brent Crude 1-month Future price of \$109.91 up a marginal 6% on the month.

Gold, having hit the dizzy heights of \$1,921 in September, remained on the side lines with the precious metal finishing

the month considerably lower at \$1,709 representing an 11% fall from its all-time high.

Currencies continued to follow the fundamentals with sterling sitting at \$1.60521 against the greenback, and €1.14682 against the Euro. The Euro itself finished the month at \$1.39987 against the US Dollar. Thanks to the (short-term) improved political sentiment in the Eurozone, this represents a 3% gain in the €/ \$ rate over the month.

Inflation and interest rates

This month's inflation figures saw both the Consumer Prices Index (CPI) and Retail Prices Index (RPI) hit historic levels. The CPI rise, at 5.2%, represents a three-year high, whilst the RPI inflation, at 5.6%, hit levels not seen since 1991.



Can they tame the beast?

The importance of September's figures is that this 5.2% CPI rate will be used to adjust government benefits and pension calculations due for payment next February, thus adding nearly £1.5 billion to their borrowing requirements going into 2012.

It is therefore cold comfort to hear that Sir Mervyn King, Governor of the Bank of England, insists that these figures represent inflation's peak and

he and his advisers expect both the indexes to drop to the long wished for 'target' of 2% by mid 2012.

Interest rates round the world		
UK	0.50%	Last change – March 2009
USA	0.25%	Last change – Dec 2008
Europe	1.5%	Last change – July 2011
Japan	0.10%	Last change – Dec 2008

The other side of the coin - interest rates - offers a more optimistic outlook with the MPC voting 9-0 in October to hold interest rates at 0.5% yet again. Indeed, there is a small cadre within the MPC that was even considering reducing the already all-time low rate by a further 0.25%. This reinforces the overall consensus in the marketplace that interest rates will not be raised until mid 2014 at the earliest.

Quantitative Easing Mk II

The Governor of the Bank of England, Sir Mervyn King, was quoted last month as saying the world faces "The most serious financial crisis ever."



Will printing money work?

So at first glance, the decision of the Bank of England to 'print' another £75 Billion is very good news for

the UK economy, but will it turn out to be the panacea that the country needs to drive growth?

It would appear that by buying that amount of Gilts and other treasury bonds (given the markets were expecting no more than £50 Billion to be made available this time around) it will release these funds into the banking system, who will in turn release those same funds to the very businesses that have been starved of working capital for the past few years. If this does indeed take place then, yes it should prove a great fillip to the economy as a whole.

However, our banks' track record has not been good in this regard. Previous QE, amounting to over £200 Billion, has not exactly seen the banks falling over themselves to lend. Indeed you would be forgiven for thinking that they had actually just hoarded the cash in their balance sheets. In their defence they tell us that businesses are in fact hoarding cash and are not seeking additional loan finance.

Another consequence of QE is that it condemns the Bank to admitting that its brief of maintaining inflation at 2% - which it has failed to do for several quarters - cannot be achieved. The previous rounds of QE have in fact increased the UK rate of inflation by approximately 1.5%, so this latest bonanza from the Old Lady can only make matters worse in this regard.

Perhaps then Sir Mervyn King's logic is that it would be far better to ignore the threat of stoking the inflationary demon, if that can help us avoid the even worse devil of deflation or worse still stagflation. All of this means that he is between a rock and a hard place strategically?

The markets' view is that stagflation will be avoided at all costs and that we have not seen the end of the Bank's largesse, with perhaps another £100 Billion being primed to hit the printing presses soon.

Jobs

So just where is the UK going to get its growth from?

The UK unemployment figures released in October reflected a dreadful snapshot of the workplace, which in turn is a reflection of the economy as a whole.

The number of people actually in work dropped by 178,000 which is the largest reduction since 2009. The increasing rate of job losses in the public sector has fuelled these figures.

So employment over the last quarter actually fell again by 0.3% and is now down to 70.4% of the work-age population. This figure flies in the face of the Coalition's premise that their current policies are creating jobs in the private sector.

Regionally, there appears to be a consistent disparity, with the North East bearing the brunt of showing an almost double unemployment rate of 11.3% (itself an increase of 1.5% over the quarter) against the South East's rate of 5.8%.

More worryingly though is the fact that youth unemployment - defined as those between the ages of 16 to 24 - rocketed to just short of the one million mark at 991,000. This represents a quarterly increase of no less than 74,000.

This means that a large proportion of school leavers and graduates are struggling to find gainful employment and therefore joining the growing band of NEET's (not in employment, education or training) that will further depress the economy.



Where have all the jobs gone?

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