

**Economic review of:**

**September 2010**

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 relative drama surrounding the election of Ed Miliband as Labour leader**

did little to overshadow news that the International Monetary Fund has given strong backing to the coalition's plans to bring spending under control. That this highly influential body has declared the British economy to be "on the mend" is accompanied by the European Commission also upgrading its forecast growth for the UK.



*Ireland has not got its spending under control as ably as the UK*

While the second quarter growth in gross domestic product (GDP) of 1.2% owes little to the new government, what it does clearly demonstrate is that we are unlikely to slip into double dip recession as a result of the spending cuts being announced (with more to come on the 20th October). The European Commission certainly thinks so, because it has upgraded its forecast for UK growth in 2010 from 1.2% to 1.7%.

This is in stark contrast with the position in Ireland, where its government is paying high interest rates on its recent borrowings (4.7% on a four-year bond and 6.2% for the eight-year version). The problem is that, while investors do not suspect default - or they would not buy the bonds at all - fears remain that Ireland cannot bring its debt under control. As previously noted, its credit rating has recently been reduced; failure by the UK government to control its spending could easily bring about a similar hike in costs for us.

**Retail sales**

**Latest retail sales figures indicate that August was 0.5% down on the previous month.** This was the first fall since January and follows a downwards revision of the July growth figure to 0.8%. There are reports that some stores have already started increasing their prices in anticipation of the VAT rise from 17.5% to 20% in January - most leading retailers say that they



*Shopping can help the economy, provided it is from savings*

will pass on the rise rather than absorbing it. The accelerated price increases will bring forward the impact it has on inflation - which will not help the Bank of England to keep the Consumer Prices Index under control.

One side effect of low interest rates should, according to a deputy governor of the Bank of England, be to encourage people to spend rather than keeping money on deposit, as the interest they can earn is likely to be less than the rate of inflation. Spending is probably what the economy needs at the moment to maintain momentum and generate the growth essential to raising tax revenues.

There is, however, a risk that people will reduce their personal resources so much that they no longer have anything to fall back on should the economy suffer another reversal. This would mean more people becoming reliant on the state for support just when state spending needs to be slashed. What the economy does not need is people borrowing to spend - as this can be inflationary.

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

**Despite fears of a double dip recession in the United States, markets generally performed strongly during September.**

In fact, the Dow Jones added a respectable 7.72% to its value during the month, ahead of the 6.19% achieved by the FTSE100, over here. The FTSE100 is now some 8% higher than a year ago, while the Dow Jones is 11% up. The UK's mid-cap FTSE250 also had a good month, gaining 7.19%, but star performer was AIM (the Alternative Investment Market), which added 13.3% during September - in fact it was also the only riser in the main indices we track in August as well, and it now stands some 21% ahead of twelve months ago.



*A sign of economic freedom in the 19th/20th Centuries - but what about now?*

Elsewhere, Japan's Nikkei225 rose by 5.35% and the EuroStoxx50 gained a more modest 4.76%; both, however are down over twelve months.

Those seeking an alternative home for their money have

continued to push up the price of gold, which gained a further 4.73% during September and now stands some 30% higher than this time last year. Oil prices continue to rise, with Brent Crude 1-month futures ending the month 7.45% higher at US\$82.31 per barrel - not far short of a fifth higher than September 2009.

**Interest rates and inflation**

While central banks keep interest rates at historically low levels, the cost of borrowing for consumers, particularly through overdrafts and some credit cards, has been rising. According to the Bank of England, average overdraft rates are not far short of 19%, despite base rate having been at 0.5% for a year and a half. Of course, the risk to lenders of default on overdrafts is greater than for, say, mortgages because they may not be directly secured against tangible assets. On the other hand, borrowers cannot simply walk away from debts; their assets are still at risk, but the banks would have to spend more to recover their money.



*Some forms of borrowing are more expensive than others*

One good thing is that when base rates eventually start to rise, it is unlikely that rates to borrowers will increase in line. This is because what banks charge depends primarily on what they pay in wholesale markets, plus a margin to cover overheads and profits.

On the other hand, steps to make banks safer by increasing the capital margins they have to maintain could increase the cost of borrowing for consumers and businesses - which may be why governments are trying to adopt a gradualist approach to this issue.

The debate over the Bank of England's base rate continues with only one member of the Monetary Policy Committee consistently standing out for an increase.

Interest rates round the world		
UK	0.50%	No change for 18 months
USA	0.25%	No change for 21 months
Europe	1.00%	No change for 16 months
Japan	0.10%	No change for 21 months

The fear is that raising base rate could be inflationary and with Consumer Price Inflation already well above target at 3.1% (4.7% if you prefer the more comprehensive RPI measure) nothing should be done that makes matters worse. Some economists argue that inflation will naturally start to fall back by 2012, once what are described as 'temporary factors' fall out of the equation. This view is supported by the fact that taking taxation out of the equation produces a current inflation rate of only about 1.4%.

**Public borrowing**

According to the Office for National Statistics, public sector borrowing in August was higher than ever at £15.9 billion. There were a number of reasons for this including

higher interest payments on index-linked bonds, but with tax receipts rising this is disappointing, to say the least. Nevertheless, borrowing for the year-to-date is down by £3.8 billion on the same point in 2009, at £58.1 billion and the forecast for the year remains static at £149 billion, which will be a 4% reduction on last year.

Spending cuts are going to be harsh - everyone knows that and some trades unions appear to be gearing up for a winter of discontent to make the cuts as unpopular as possible. Whether the new leader of the Labour party will support them in this, or follow Alistair Darling's line that the party must be "credible" in its plans for the public finances, has yet to be seen. What is clear is that, without further action, debt could exceed 150% of GDP within thirty years (Sunday Times 12th September 2010).



*Can we afford an independent nuclear deterrent?*

A 'straw poll' by the BBC suggests that most people want to see cuts in welfare benefits. However, in a nation where four million households have nobody in work, it is essential that this is handled sensitively. There are more than a quarter of a million households where all members are sick, injured or disabled (Times 9th September 2010); these should not be further disadvantaged simply to cut benefits for what are seen as scroungers.

**Housing market**

House prices have been weak for some time, but of greater concern is the volume of sales. The level of home sales is well down on three years ago and mortgages fell by 14% in August, according to the Council of Mortgage Lenders with mortgages of just £11.4 billion being agreed, the lowest level for August since 2000 and almost two billion less than in July. This represents just 31,767 deals.



*The housing market is slow*

There are concerns that the underlying cause is that people are reluctant to buy for several reasons. One may be that they expect a further fall in prices and wish to benefit; the other is that they are concerned about employment prospects. While unemployment was held down during the recession, there are fears that government spending cuts will make matters worse, particularly in capital construction projects.

These fears may be irrational, since the number of people unemployed in August was still under 2.5 million, while 286,000 more people were in work in the three months to July than the previous quarter. If the private sector can make up for public sector job losses, confidence could return to the housing market.

**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

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