

Economic review of:

September 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 Eurozone crisis simply won't go away. Some argue that Greece should never have been allowed into the euro; that they may have been somewhat economical with the truth, in order to qualify. Whether or not this is the case, is now academic; they are in and neither those countries also inside the zone or we outside it who trade significantly with Europe can afford to see the euro collapse.



Time is running out

The US - which as reported last month contributed to financial uncertainty itself by failing to resolve its own budgetary problems until the eleventh hour - has been pressing for Europe to get its act together. At the time of writing, it appears that some form of agreement is coming into focus; slowly.

At the heart of the problem appears to be that the better off states do not see why they should pay for what they regard as the profligacy of the PIGS (Portugal, Italy, Greece and Spain), while the latter countries do not see why they should accept a lower standard of living on the say-so of a few wealthy northern European states.

The simple fact is that we all have to share the pain. The UK will not be exempt from the bailout, through its participation in the IMF; but failure to resolve the debt problem will plunge the west into recession. The issue does not stop there; as suggested in the following article, failure to make similar compromises in the UK could make our recovery slower than that in other countries.

What we need is political consensus

With the party conference season in full swing, what the country needs most at the moment is not so much a plan "A+" or even "B" but simple political consensus - over the long term, not just for Christmas - that enables the different parties to agree at least the broad objectives, even if the precise way of achieving it is beyond them.



Consensus is essential for the long term

In fact, this is not a pipe dream because the main parties - even Labour, which was largely responsible for the country maxing out its credit card over the past decade - generally appear to agree that deficit reduction is essential. Control over the banks is also essential - as recent events at UBS, where it may turn out that a lack of internal controls was what allowed a 'rogue trader' to ratchet up debts of more than £1.3 billion, have proved. It is not however of much value to castigate the banks for pursuing what has proved on many occasions to be financially suicidal strategies when regulation has failed to ensure that sufficient checks and balances were in place to prevent financial melt-down.

The political parties should, perhaps, recognise that the country is still facing an economic crisis by agreeing a joint long term strategy that will calm the nerves of over-excitabile markets. This will require give and take on all sides, but the coalition has already demonstrated that this can be achieved by people of good will - and there are precedents in other times of national crisis including the Second World War.

Political self-interest must be laid aside and everyone pull together.

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

FTSE 100 lost 13.74% of its value during the third quarter of 2011, its worst quarterly decline since 2002, with September itself accounting for -4.93% of its fall. Actually, after it lost more than 7% during August, that seems almost a positive result and to be fair, there were some positives within the month that saved markets from even worse results. Most of the bad news related to the euro crisis in southern Europe, although poor data from the US did little to help matters. A late 4% rally in the FTSE100 was followed by renewed fears over whether Greece could ever solve its debt crisis that led to a further market fall. However, the index managed to stay above 5,000 points, to remain positive compared with its recent low point of June 2010. For those taking a longer term view of shares, the FTSE100 ended the month some 20.67% below its long-term trend.



By no means a headlong dive

Elsewhere, the Dow Jones lost -6.03% of its value, the

Eurostoxx50 **-5.32%** and the Nikkei225 **-3.98%** and of the leading indices we follow, only the Dow Jones and Nasdaq100 are even marginally above their levels of a year ago.

Oil pleased many economy-watchers (and drivers) by losing **-8.83%** during September to end at \$103.95 a barrel for Brent Crude 1-month futures, while gold, frequently seen as a safe haven when markets are weak, lost a massive **-10.57%**, to end at \$1,624.32 per troy ounce. In currency markets, sterling lost **-4.03%** against the US dollar but gained 2.83% against the euro.

Inflation and interest rates

Inflation for August returned to its eye-watering level of 4.5%, as measured by the Consumer Prices Index. The - for many people more realistic - Retail Prices Index was even higher at 5.2% and this, together with a squeeze on earnings (for everyone except the directors of major companies, it seems) means that most of us feel worse off. To some extent, this is a price we have to pay for getting a grip on public spending and if this reduces domestic demand then it is even more important than ever that exports are increased, in order to maintain some growth in output.



Enough to make you cry!

There is some scope for optimism that inflation may start to fall sometime soon, because producer input prices in the UK fell by 1.9% in August; while this will not guarantee a fall in the rate of inflation, it is a positive indicator.

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

Despite comments from former Monetary Policy Committee member Dr Andrew Sentance that interest rates must be increased by 0.5% to curb rising prices, there is little

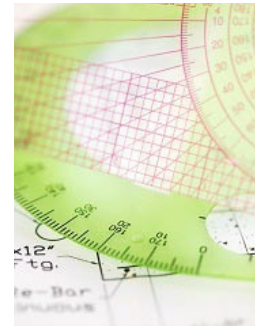
likelihood that this will happen any time soon because this could slow growth even more. However, the Bank of England is considering further quantitative easing (printing money electronically) in order to stimulate the economy.

It estimates that the previous £200 billion round increased gross domestic product (GDP) by between 1.5% and 2% and was equivalent to having cut base rate by between 1.5% and 3% in terms of economic impact. A further round now could provide a further fillip to GDP, but also has the potential to increase domestic inflation. Should oil prices continue their recent (somewhat erratic) slide, however, this could limit any tendency for higher prices.

Growth prospects

According to a city joke, economic commentators have predicted 14 of the last three recessions. In other words, there seem always to be those prepared to predict disaster on the basis that, if correct, they can say 'I told you so' and, if

wrong, nobody will remember anyway. However, when the International Monetary Fund predicts the chances of a return to recession, it is worth listening to; in this case it says the UK has less than a 'one in five' chance of doing so. On the other hand, its growth forecasts for the UK are only 1.1% this year (1.6% next) compared with 4% this year and next globally, 1.6% and 1.9% respectively for the west generally and 6.4 and 6.1% respectively for the emerging economies.



A new Marshall Plan needed?

What this tells us is that, if we can export successfully to the emerging countries (though the output slowdown and job cuts at BAE Systems will not help the cause), we can grow on their coat-tails. It is therefore reassuring that the Bank of England's Agents' Report for September suggests that export growth remains robust, even if domestic manufacturing output has slowed. Retail sales in August were 0.2% down according to the Office for National Statistics (ONS), but 1.2% down for non-food items, according to the British Retail Consortium.

What might help the UK economy could be to shift government expenditure from current spending to capital (infrastructure) spending. To do so would boost the construction sector, which is often the bedrock of growth, and need not, with gilt yields falling, cost too much. Interest repayments are already forecast to fall by £6 billion in 2014/15 due to lower costs.

Jobs

The number of jobless in the UK grew by 80,000 in the second quarter of 2011, to reach 2.51 million. According to the ONS, the largest proportion of this was 16 to 24-year-olds so that youth unemployment is now almost 1 million. Part of this is likely to relate to school leavers and those registering for work during the universities' long vacation, but nevertheless, it is a horrific figure and could explain (but not excuse) some of the frustration that led to the summer riots.



Empty classrooms boost jobless figures

There has, of course, been a massive reduction in public sector jobs, with 111,000 disappearing during the second quarter; this could account for some of the shortfall in jobs for young people. The ongoing spending cuts will mean that this trend will continue and it is essential that the private sector creates as many new jobs as possible, not just for those made redundant from the public sector, but also to help train the young. As part of this 'social compact' however, the young will need to acknowledge that they must both learn on the job and also give value to their employers; for their part, many employers may need to abandon their preconceptions about the low educational standard of many young people.

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