Monthly

Economic Review

Economic review of: August 2009

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; we are always ready to discuss your individual requirements and hope you will find this review to be of interest.

Should you require any additional information about your investments, pension planning or family / business protection, please do not hesitate to contact us using the details at the foot of the next page.

Retailers continue to tell the Bank of England's Regional Agents that sales are increasing, most prevalently in food sales, although the same is also true of non-food items except 'big ticket' items which continue to be well down. That said, sales of new cars have seen some modest growth; a credit to the car scrappage scheme.

Food sales at least are on the up

However, while tourism has benefited from growth in 'staycations' (better than spending hours in an airport queue), the restaurant trade is suffering. But the pace of decline in many service sectors has slowed.

It is, of course, the construction sector that continues to suffer the worst effects of the downturn; which is hardly surprising, because builders cannot borrow to develop property and buyers are still finding it difficult to find mortgages.

Employment prospects, on the other hand, look relatively strong with most of the Bank's contacts reporting that they were more confident than earlier in the year and that, while not actively recruiting, were not currently considering further redundancies.

Inflation may be good for balloons, but not savers

The threat of stickyflation

Some time ago, Graeme Leach, Chief Economist at the Institute of Directors, warned of the danger of 'stickyflation'. He defined this as low or zero economic growth, accompanied by inflation.

With the Retail Prices Index (RPI) running at an annual rate of about -1.4%, this might appear to be a strange time to be worrying about inflation. But when you look at the Consumer Prices Index (CPI), which is what the Bank of England has to monitor, to keep within its target, the actual level is almost 1.75% a year.

The danger of inflation is often disregarded during a recession, perhaps because people are less inclined to spend when the economy is weak, so there is no upwards demand-related pressure on prices, while costs should be falling. However, because of globalisation some costs are rising and these can push up prices.

So can poor harvests. Dr Vincent Cable MP points out (The Storm, 2009 pp75-76) that a small excess of production over demand is likely to have a significant impact on prices, although speculation can add to volatility.

Inflation always hurts those on fixed incomes, such as pensioners. And with interest rates at such low levels, this group is already suffering from reduced incomes. If prices rise they will be even worse off.

Of course, deflation is also a threat, but in a different way. Falling prices can be a good thing in the short term, because consumers' money goes further. The problem is that if this becomes a longer-term trend, people start holding back on major purchases, as we are already seeing, and this feeds through to lower GDP. A downward spiral can result that is difficult to prevent.

The best option for all of us is to see economic growth returning gradually, to be accompanied by only modest inflation. The problem is that the Bank of England's quantitative easing is potentially highly inflationary, because it puts money into the economy. Fortunately, the banks appear to have got 'sticky fingered' with the money, adding it to their balance sheets, so it may not be such a threat.

Markets are rising, but there will inevitably be downswings later

Markets (Data compiled by the Insurance Marketing Department Ltd.) August may not have provided the 'Barbeque Summer' that we were told to expect, but for equity markets the effect has been just as good. The FTSE100 built on its July growth with an additional 6.52%, while the mid-cap FTSE250 managed a massive 10.22%

increase. In the US, the Dow Jones was not far behind with a 9.4% growth over the month, although the Nasdaq100 'only' managed 3.54%. Elsewhere, the Eurostoxx50 gained 5.19%, while the Nikkei225 ended 1.69% up.

Oil prices have continued to rise, ending the month 1.5% higher at US$72.79 a barrel for Brent Crude 1-month futures. Sterling fell against the dollar and euro, by -2.23% and -3.02% respectively, probably as a result of nervousness over increased 'quantitative easing' here, although other factors are at play. The continued bounce in property values – Nationwide shows prices rising by a further 1.52% in August – could prove to be misleading, because property is relatively scarce as fewer new houses are being built and prices are still high compared with average earnings, in historic terms.

America has seen it all before

1907 – Déjà vu

Many people may be unaware that one hundred years before the Credit Crunch, a similar event took place – largely in the USA, rather than elsewhere, although there were global implications.

This event, known as "The Panic" was a run on several banks resulting from some ill-advised speculation by a few businesses that revealed an interlocking series of loans that threatened to bring down the entire US banking market. Only concerted efforts by JP Morgan and some of his colleagues in the New York banking community staved off disaster.

The reason for mentioning this is that the speed of recovery was quite remarkable; within two years industrial productivity in the US was back to its pre-Panic level. Yet nobody reading about the events of those far off days could fail to recognise that the crisis was every bit as severe as the recent Credit Crunch – and that there are significant parallels between the two.

This, in our view, gives a degree of confidence that has been lacking in the press for some time. The economy will recover and so will investment markets. All we need do is hold our nerve. The upswing already appears to be in progress in certain areas; certainly Ben Bernanke, Chairman of the US Federal Reserve thinks so, according to a recent statement in Wyoming and data from the UK Office for National Statistics also suggest improvements.

Economy

Interest rates round the world

UK	0.50%	No change
USA	0.25%	No change
Europe	1.0%	No change
Japan	0.10%	No change

We must recognise that the UK economy will take some time to recover – largely because borrowing here was already high, compared with tax revenue, even before the downturn started. This resulted in massive additional borrowing to pay for the bank bail-outs (which could not have been avoided even if we had no previous borrowings) but also to help with 'Keynesian' spending our way out of recession.

Waste is systemic, rather than attributable to individuals

It should therefore come as no surprise that the UK government was forced to borrow money in July (a month when it usually has a bumper inflow of tax monies) for the first time since 1996. Its £8 billion requirement for the month drove public debt up to £800 billion.

Put another way the government owes 56.8% of gross domestic product (GDP) or £13,000 for every person in the land – even new born children. In 30 years of records, the proportion of GDP has never been so high – although in theory at least, selling off our stake in the banks could eventually reduce this significantly.

The problem is, of course, that tax receipts are down, especially from Corporation tax (-38%), Inheritance tax (-37%) and Stamp Duty (-24%), while spending on benefits is up by 10%.

Public sector inefficiency

According to the Office for National Statistics, productivity within the public sector fell by 3.4% between 1997 and 2007. This may not sound much, until you realise that during the same period, private sector productivity has risen by some 27.9%.

When you bring pay into the equation, public sector costs rose by 30.5% compared with the private sector and it has been calculated by the Centre for Economics and Business Research (23/8/09) that the cost of this to taxpayers is £58.4 billion a year more than it needs to be – or 42% of the total bill for income tax.

Newton thought about more than physics

Nobody wishes to criticise individual public sector workers; most provide a valuable service and are hard working. The issue is whether their efforts are correctly directed; the figures suggest not.

Credit

According to words attributed to Sir Isaac Newton (Master of the Royal Mint for 30 years from 1696), "Credit is a present remedy against poverty & like the best remedies in Physick works strongly & has a poisonous quality."

The point is that credit is great for oiling the wheels of commerce, but that over-reliance on it can cause significant problems. Firstly, if it is too plentiful, it can be inflationary (which is a potential danger of quantitative easing). Secondly, when it becomes unavailable – or in short supply – it can constrain economic growth – as we have seen as a direct consequence of the Credit Crunch. Nothing changes, does it?

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