Monthly

Economic Review

Economic review of: October 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.

Press reports suggest that, more than 30 years after Jim Callaghan's "Winter of Discontent", Gordon Brown could soon face his own version. The postal workers' action and a ballot amongst BA cabin staff aimed at striking against proposed changes in working practices and a cut in pay scales for new (but not existing) employees could be just the start, especially with an on-going refuse collection strike in Leeds.

Is this the winter we have to look forward to?

Fear of more industrial action throughout the UK makes it is unsurprising that headlines highlight the prospect of further disruption. However, trade unions need to be aware that we are in a difficult economic situation and, while some may feel that local authorities have no alternative but to come to the negotiating table, this is certainly not true of the Post Office and BA. Both of these could – in a worst case – go out of business if competitors take advantage of a period of industrial action. Everyone deserves a fair wage – and to be consulted about changes in working practices – but putting your employer out of business (or at least making them less competitive) is not a good idea.

Inflation and economic growth


If demand exceeds production, inflation can follow

Inflation is partly generated by the gap between production and demand. According to the International Monetary Fund, the UK's gap is currently -5% which, if not causing inflation, is certainly slowing the rate in its decline. Inflation is also driven by import prices which, due to a previously weak pound, have been rising. It is probable that inflation has reached a low point and could start rising over the next few months. This makes any potential decision to increase quantitative easing (possibly with an additional £25 billion injected into the banking system) more difficult, as increasing the money supply can be inflationary.

The BofE will also have to be careful as the VAT hike in January (and tightening fiscal policy from April) could slow demand and dampen economic growth (combined with rising prices, this could cause stagflation). It already knows, from its own Agents' summary of business conditions (October 2009) that the value of consumer spending is down slightly. This is due to a fall in housing- and services-related spending, although aggressive retailer discounting has also played its part. The same publication also highlights that pressure on capacity may remain above average, but is weakening due to falling consumer activity. This could impact over the longer term if firms cut back on investment as they can more easily satisfy demand.

Markets (Data compiled by the Insurance Marketing Department Ltd.)
Following a three-month run of growth (20.8% in the case of the FTSE100), October was a period of consolidation in most markets, with the FTSE100 losing 1.74% and the mid-cap FTSE250 2.81%. In fact, growth had continued throughout the first half of the month, but poor government borrowing figures then caused a reversal. News that we are still in recession didn't help either.


Share values often take on the shape of an alpine skyline

In the US, the Dow Jones was virtually unchanged at the end of the month after having peaked mid-month; the Nasdaq100, however, lost 3.64% during October. Despite the fact that France and Germany are already out of recession, the Eurostoxx50 also suffered, losing 4.5% of its value, reversing all of September's gain and some of that from August. In the Far East, the Nikkei225 lost ground for a second consecutive month, ending 3.26% down despite a mid-month recovery.

Latest house price figures from Nationwide indicate that prices continue to recover slowly, with the index now 1.67% higher than last year. Gold has continued its rise, gaining an additional 3.89% to end the month at $1,046.36 per ounce, while oil also (unfortunately, for motorists) continued to recover from its August reversal, ending the month 8.88% higher at $75.20 per barrel for Brent Crude 1-month futures.

Sterling is still considered by many to be undervalued and it gained 2.86% against the dollar and 1.61% against the euro.

Interest rates and the recession

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

Australia increased its base rate by 0.25% on 6th October but most others remain unchanged. Since it might be two years before UK GDP recovers to its pre-credit-crunch levels, a hike in rates here is unlikely for some time.

As readers will be aware, the latest figures show that we are still in recession. However, official data is often subsequently revised (up or down), as more detailed underlying figures become available, so it is quite possible that we have already reached the bottom and that things are not as bad as they may seem. It is quite conceivable that the year end figures will show an election-chances-boosting upturn.

Even the Old Lady of Threadneedle Street was caught out

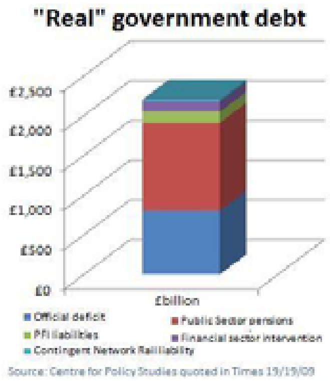
Certainly the BofE was caught out as it had predicted a 0.2% rise, compared with a 0.4% drop in GDP. We are now in the longest period of falling GDP on record.

Government borrowing

In April 2008, before recession started, the Public Sector Borrowing Requirement (PSBR) – the amount of additional borrowing required during the year to cover expenditure – was estimated at £38 billion for 2009-10 (which represents just 2.5% of GDP) By April 2009, PSBR was forecast to be £175 billion for the year (12.4% of GDP). This makes total borrowing roughly 59% of GDP.

What is needed is not just a hike in taxes but a real reduction in spending. According to the (right wing think-tank) Centre for Policy Studies, government debt could be almost three times as high as the official figure at £2,200 billion (157% of GDP) if you take into account the full cost of PFI projects (except local ones), the cost of public sector pensions and contingent liabilities for Network rail.

Conversely, Karen Ward (UK Economist at HSBC) is quoted in the Sunday Times (25th October) as feeling that the upturn in the stockmarket could well generate additional revenue



Debt could be up to three times as much as recorded

for the Treasury. This would mean that its forecasts may be overly pessimistic. The 2009/10 out-turn could be some £20 billion better than forecast, rising to £131 billion less than Treasury predictions by April 2014. In her words, public finances change "from appalling to merely very bad".

Banking

Mervyn King, Governor of the Bank of England (building on what new Monetary Policy Committee member Adam Posen suggests) says banks should be split between 'retail' and 'investment' to avoid them being 'too big to fail' and that state support for their investment banking activities – so-called "casino banking" – should be withdrawn.

The Prime Minister immediately retaliated by pointing out that Northern Rock had no 'investment' arm and Lehman Brothers no 'retail' operation and the banks themselves would have us believe that splitting is not necessary. Angela Knight, chief executive officer of the British Bankers' Association, says the key issue is not one of breaking up banks but of financing the economy and that big businesses may want big banks which offer a range of products and services while individuals may look to something smaller. Large universal banks are the way forward, claim the bankers.

We should not forget that the banking crisis was only prevented from being a global catastrophe with taxpayers' money. This gives us the right to say how they operate; and a consensus view appears to be that our money should not be used to pay massive bonuses such as RBS's £4 billion (of which the top people get up to £5 million).

The government and regulators appear to be unable to do anything to prevent what most of us see as an abuse. But it is difficult to see why banks should not simply be told that they cannot pay bonuses - or increase basic remuneration - until they have repaid every penny we lent them to bail them out of the mess of their own making.

Is this the sort of banking we should be supporting?

They may say that the high earners would simply leave and work elsewhere for more money. Well, unless they can prove that nobody could do just as good a job for less money, one might say "OK, let them go".

Issued by: **CBK (Colchester) Ltd.**
Bentley House, Forge Lane, Great Bentley, Colchester, Essex. CO7 8GD
Telephone: 01206 257501 - Fax: 0270 0631072
Email: info@cbkcolchester.co.uk - Website: www.cbkcolchester.co.uk