Monthly
Economic Review

Economic review of: February 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.

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.

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Is it perverse to find it reassuring that even professional economists cannot agree over what is best for us? No sooner do one set of them write to the Sunday Times demanding faster action on reducing government borrowing, than another group writes to the Financial Times with the reverse call. No wonder George Bernard Shaw apparently wrote: “if all the economists in the world were laid end to end, they would not reach a conclusion”.

Not if, but when, do the cuts start

The fact remains that every political party knows that whoever wins the next election, there will have to be cuts in government spending and an increase in taxation, if borrowing is not to increase further.

The real question is about timing; will immediate cuts help reduce debt and build confidence, or simply slow the rate of economic recovery and result in a double-dip recession? The architect of spending your way out of a recession was John Maynard Keynes; but the last time it was recommended in 1981, Geoffrey Howe seems to have ignored the advice ... and was proved right.

The need to reduce borrowing is self evident. One only has to consider what has been going on in Greece for that to be perfectly obvious. Governments with high borrowing levels, relative to Gross Domestic Product (GDP) and no clear plan to cut their deficits are likely to find it more difficult to borrow in future, when existing debt has to be repaid or replaced. Bond markets need to see action, or they will bet against the government and make interest rate rises inevitable.

Can we ignore Southern Europe?

Much press comment has centred on the financial crisis in Greece, but Italy and Portugal are also facing falling growth accompanied by high unemployment and government debt. While in Greece, debt is 124% of GDP, the position in Italy is little better at 115% with Portugal at 76% (our rate is 62%). Meanwhile, Spain’s unemployment rate is 19.5% and that in Portugal 10.4%, compared with just 7.8% in the UK.

All these are in the Eurozone and, while we are not, there is a significant level of trade between us and those countries that are. So anything that adversely affects them could hit the UK as well; if the Euro’s value falls because of their economic problems, the benefit we have received from a weak pound will disappear.

Thousands of years of democracy but still in debt

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

After what may have started off looking like a potentially turbulent month, markets were generally less spooked by events in Greece than might have been expected. The FTSE100 gained 3.2% during February which, while not making up for January’s fall, still puts it ahead in quarterly terms and is a whopping 39.8% up over the past 12 months. The mid-cap FTSE250 grew by a more modest 1.42% during the month, but this was sufficient to cover the previous month’s losses and puts this index more than 54% up over 12 months.

Elsewhere, the Dow Jones rose by 2.56%, giving it a 12-month growth of 46.19%, while the Nasdaq100 managed a ‘chart-topping’ 4.23% rise during February. However, the Eurostoxx50 was down -1.47% while the Nikkei225 lost -0.25% during February.

Gold retains its appeal

According to the Nationwide House Price Index, average prices fell by -1.0% during February, but the rate of annual increase rose from 8.7% to 9.2%. Oil prices were 8.58% higher, which is again bad news for motorists (and potentially for home-owners’ energy bills), while gold has bounced back by 3.92% after two months of falls. Although it has yet to regain its high point of mid-November, when it briefly breached the $1,200 per ounce level, it remains at a gravity defying level compared with five years ago, when it was only a little above $400 per ounce. This could be taken as indicating a lack of confidence in alternative asset classes, amongst some investors.

Is the recession really over?

Is your glass half full or half empty?

As reported last month, it is far from clear whether or not we are out of the woods, yet. While we now have revised GDP figures for the last quarter of 2009 showing that the economy grew by 0.3% (with the possibility of a further upwards revision to come), many people still foresee the risk of "double-dip" recession where we slide back into negative GDP growth. One reason for this concern is that according to the Office for National Statistics, high streets have reported a -1.2% fall in sales volumes in January, -1.8% if you count petrol and diesel. This represents a much larger monthly fall than January last year and comes on top of disappointing November and December figures, both comparatively worse than the end of 2008.

On the other hand, the Bank of England regional Agents' summary of business conditions for February shows that, year-on-year, the figures are actually more positive with the Christmas/New Year sales figures well up on a year earlier.

Consumer spending is important because, historically, this has proved to mirror GDP growth quite closely. Interestingly, government spending has had less influence on GDP in general, although during a recession special considerations apply. One thing seems certain; as the Institute of Directors' Graeme Leach puts it, this is a "feel-bad recovery" partly because incomes are rising so slowly (1.2% in the last quarter of 2009, compared with a year earlier). If house prices do not rise and boost consumer confidence, this could do as much - or more – damage as increased unemployment might.

Inflation and interest rates

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

Inflation soared in January to 3.5% for the Consumer Prices Index (CPI) or 3.7% on the more traditional Retail Prices Index (RPI), which includes housing costs. This was partly due to the reintroduction of the 17.5% VAT rate, although rising energy costs were also to blame.

The Bank's most recent Inflation Report suggests this is a blip, which it expects to see fall away closer to its 2% CPI target towards the latter part of this year. Actually, the Bank does not go in for exact predictions, but prefers a 'fan prediction' which gives it an increasingly large margin of error as time progresses from the present. Nice to look at … but useless for planning.

Interestingly, the Bank's Monetary Policy Committee decided against increasing quantitative easing beyond its current £200 billion. It may be that this will be extended after the election, but any extension of the special liquidity scheme that helped fill the £300 billion funding gap for mortgage lenders, appears to have been ruled out.

On the subject of interest rates, readers might like to note that while base rates have remained level for some time, credit card rates have hit an all time high, according to Moneyfacts, with an average of 18.5% now being charged compared with just 14.8% in 2006.

The workplace

Rising costs are squeezing margins

According to the Bank of England Agents' summary, manufacturing activity has grown since last summer, but while reports of expansion outweigh those of shrinkage, there is little real sense of strong or consistent growth. On the other hand, the level of unemployment slowed in the last quarter of 2009 and employment intentions have continued their upturn, based partly on the fact that labour costs have remained within control. For 2010, few employers expect to offer more than 2% pay increases, but pension related costs are expected to rise.

On the negative side, material costs have been increasing since summer and excess production capacity continues to depress the prices firms can charge to customers. This squeeze on margins will have to give way sometime, if business failures are not to increase.

State co-ops

Co-operatives already work very well

According to (dimly remembered) history lessons, workplace collectives are called Soviets and the first one was established in Ivanovna-Voznesensk during the 1905 Textile Strike. This might make it superficially surprising that a conservative politician should propose using co-operative businesses as a way of reducing public sector costs. On the other hand we have a perfect example of one working highly effectively in the private sector already. The John Lewis Partnership, which includes Waitrose, was given to its employees by its founder's son in 1928.

I am sure that there are a lot of considerations on both sides of the debate; but making, for example, dustmen responsible for not only collecting our rubbish, but also ensuring that it is done in such a way as to generate a profit for them could have considerable appeal.

Perhaps we could do the same with the government (of whatever colour)!

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