

Our monthly economic review is intended to provide background to recent developments in investment markets as well as to give an indications 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.

Bruce Janman



The tiger economy is under threat

The crisis in Ireland proved to be the main economic influence during November. Total cuts of €10 billion, including €2.8 billion for welfare and a 25,000 cut in public sector jobs, will be accompanied by a VAT increase from 21% to 23% by 2014 and €5 billion in new taxes. This is in addition to the €14.6 billion savings made since 2008. There will not, to the disappointment of France and Germany, be any hike in corporation tax from 12.5%.

Ireland was, of course, once the 'tiger' economy of Europe (built partly on housing boom) and the questions remain: will the support package be adequate - and will government survive long enough to see it through?

PIGS at risk

The southern EU states of Portugal, Italy, Greece and Spain are also far from secure; Portugal in particular is vulnerable to attack in bond markets with a bail-out appeal expected soon by some commentators. It has already imposed austerity measures including a 5% public sector pay cut and frozen pensions.

One thing is certain, while we may be pleased not to be part of the euro, we certainly do not want to see it collapse (which is why we are helping Ireland at a time when we are cutting our own spending). Not just Ireland, but the rest of Europe are major trading partners of ours and their stability is in our interests. In 2009, HMRC data indicates that 54% of our exports went to Germany, France, The Netherlands, The Irish Republic, Belgium, Spain and Italy. This was worth some £102 billion. By contrast the US took just 17.7% of our exports (£33 billion).

UK economy

Unemployment fell slightly during the third quarter to 2.45 million, but the overall rate remains at 7.7%. Overall employment jumped by 167,000 (mainly part-time) to 29.19 million over the same period.

According to the independent Office for Budget Responsibility (OBR), Gross Domestic Product (GDP) growth, which has been confirmed as 0.8% for the third quarter of 2010, is expected to reach 1.8% this year, and by a (slightly slower than previously estimated) 2.1% next year. The OBR said its relatively sluggish medium-term outlook reflected the gradual normalisation of credit conditions, efforts to reduce private sector indebtedness and the impact of the Government's fiscal consolidation.



Exports could prove a major driver of the recovery

Faster growth would depend on consumer confidence, but because economists feel that some households may not yet have 'factored in' the forthcoming fiscal consolidation, this is not expected. Another factor that could drive growth would be if businesses reinstated previously deferred investment projects (see Business section, below).

The Bank of England Agents' Summary for November suggests that retail sales continue to ease, although consumer services have strengthened slightly, on higher prices. However, export growth remains robust while global demand continued to rise, albeit unevenly with Asia growing fastest.

On the negative side, the Institute of Directors' respected Chief Economist, Graeme Leach, suggests that GDP growth will be just 1.2% in 2011, producing the "square root" shaped recovery that some people predicted. If this is the case, then more spending cuts may be required than those included in the recent spending review. Others, however, such as Kevin Daly of Goldman Sachs take a more positive view, suggesting that our recovery is faster than following the past five significant financial crises (Spain in 1977, Norway in 1987 and Japan, Sweden and Finland in 1990).



Might the euro's problems drag markets down further?

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

Markets had been having a good start to November, but the euro crisis, discussed above (PIGS at risk) took the shine off all the leading indices. Developments in Korea may also have caused some instability as concerns grow over possible armed conflict after half a century of post-war hostility, yet the nearest leading economy, Japan, saw its Nikkei225 index end the month a massive 8.54% higher, so this may not be the major factor that it at first appears. In the UK, the FTSE100 was -2.59% down, while the mid-cap FTSE250 lost -2.17%. The US fared better with the Dow Jones losing only -1.01% and the Nasdaq100 -0.37%. As you might expect, given the euro's problems, the Eurostoxx50 was the main loser at -6.82%. Nevertheless, all the main indices we track are up over twelve months, with the exception of the Eurostoxx50.

Interestingly, the Alternative Investment Market (AIM), which actually gained 4.44% during November, is 30% higher than this time last year.

Sterling gained 3.96% against the euro, but lost -3.04% against the US dollar, during November, while the price of Brent crude 1-month futures rose by 5.04% to US\$87.34.

The Land Registry's house price index for England and Wales shows that prices fell by 0.8% month-on-month last month, the largest monthly decline since February 2009.

Interest rates and inflation

Inflation, which stood at 3.1% in September, is expected to remain above 2% throughout 2011, according to the Bank of England's November Inflation Report, partly due to the VAT rise due in January and rising import prices. However, it is then expected to fall back, although the probability of inflation remaining above target remains at about 40%-50% until the end of 2013, according to the Bank.

UK interest rates remain at their historically low level for a 20th month, despite Monetary Policy Committee member Andrew Sentance continuing to vote for a rise to 0.75%. He believes that this is essential to ward off the need for an even more dramatic rise later on which, he argues, could hurt business and consumer confidence. Dr Sentance argues that a rise is essential in order to reduce inflation to its target 2%, so it would be better to bite the bullet sooner, rather than later. Conversely, low interest rates are likely to benefit stockmarkets, as investors seek better returns than are available from gilts and deposits.

Interest rates round the world

UK	0.50%	No change for 20 months
USA	0.25%	No change for 23 months
Europe	1.00%	No change for 18 months
Japan	0.10%	No change for 23 months



The Fed knew it was risking the dollar when it 'eased' again

Another MPC member, Adam Posen, wants to increase Quantitative Easing (QE) - often described as printing money, although it really involved the Bank in generating some £200 billion electronically to help the banking sector - by £50 billion. American economist Dr Posen says that further QE would increase economic stimulus by injecting more cash into the banking system (banks have to rebuild even stronger capital bases to meet more stringent solvency requirements). In this he reflects the thinking behind the recent US move (called QE2) that injected a further \$600 billion into the American banking system. Apparently the Federal Reserve was aware that this could drive the dollar downwards - which it did.

Business

Businesses continue to be affected by the fact that many of their pension schemes are in deficit. Thanks to a change in the reporting regulations some years ago, they have to show the extent of any pension deficit in their accounts and this has a depressing impact on share prices. However, they would have to make good the shortfall in any event and despite Herculean efforts to do so, FTSE100 companies still had a £66 billion pension deficit at the end of September, according to Pensions Capital Strategies. Apparently, only 6 of these leading UK businesses have pension schemes that are in surplus, while 10 have deficits that are actually greater than their market valuation.



Companies are starting to reinvest

Following an unprecedented decline during the recession, recent ONS data suggest that business investment began to grow again during the first half of this year. According to the Bank of England Agents' Summary for November, investment intentions for the next twelve months are stronger than outturns for the past twelve months. Those companies not proposing to increase investments were inhibited by uncertainty over demand and capacity considerations, whereas those companies that do intend to increase are largely resuming previous plans or reacting to other external stimuli.



Internal consumer demand could make life difficult in China

China

China's leading credit agency has downgraded the US to "A" as a result of its additional QE, on the basis that there has been a dramatic decline in its intention to repay debt. This is likely to be a political, rather than an economic judgement. However, China is not free from its own banking issues. Its banks are lending more than the government wants and a breach of 7.5 trillion yuan annual lending limit is likely very soon.

The fear is that China could overreact in order to put a lid on inflation, which was 3.6% in September; to do so could harm China's global competitiveness. China's annual growth in the third quarter was 9.6%, compared with a 'target' of 8%; not far above its aim, but much faster than much of the rest of the world. Inflation could lead to demands for higher wages, which will further push up prices and potentially make it less competitive globally.

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