

Weekly Comment

Global Economics & Strategy

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“Out of Sheer Rage”

UK political crisis – the financial markets

This week this note is being written in a rage. Normally when writing about economics or the financial markets the appropriate state of mind to work oneself into is a sort of Zen-like meditative trance; the aim being, to achieve a degree of inner calm from which a sober, reflective view of prevailing conditions might flow. Not on this occasion! The title is eye-catching, but so is the subject matter. In fact the writer of this note normally burrows into his eclectic (and increasingly ancient) CD collection in the hope of discovering song titles which might stand out and encourage readers to take an interest. On this occasion tradition has been thrown to the four winds and a book title has been selected. You should read it, if you haven't already. Ostensibly about D.H. Lawrence, it is also a highly amusing voyage of self-discovery by an author (Geoff Dyer) who is held in increasingly high regard in literary circles and is also a close personal friend. So what? This week the writer is raging about the relationship between the political and the economic cycle.

Recent local and European election results have delivered a severe blow to the ruling Labour Party. The Party picked up a mere 16% of the popular vote and was reduced to third place behind the UK Independence Party, once a fringe grouping. Actually, that's not what the rage is about at all. The writer is studiously apolitical and generally sells his vote, shamelessly, to the highest bidder at election time. The rage is about the implications stemming from what has been reported as a humble prime minister goading and wheedling disaffected back benchers to support him as the best man for the job. I mean COME ON!!! Mr Brown presided over extreme profligacy during his period as Chancellor of the Exchequer, a profligacy which may, in part (possibly large part) be responsible for the dire state in which the UK economy has now fallen. Yes, clearly there is an international aspect to what is, after all, a global “Great Recession”, but that does not mean that domestic policy mistakes were not made over the decade preceding financial and economic melt-down. Mr Brown is learning the hard way Margaret Thatcher's observation that one can't beat the markets. It's all very well holding a live and highly venomous snake, as the markets can be, by the tail. The problem comes when the financial market snake becomes vindictive, regards you with a steely eye, and swings round to try and bite you!

Regret is a word that may privately haunt the prime minister, even if he disguises his inner turmoil well under the spotlight of public scrutiny. “No more boom and bust!” Oh dear! The writer knows what regret feels like. Once confronted by the school bully over some trifling issue the latter wound up for a confrontation by saying “Do that and you'll regret it!” Well the writer is that kind of person and went to that kind of school. Couldn't see a boundary without trying to push it. I did, and I did!!

Actually, the markets have been relatively kind to Mr Brown over the past few weeks. In part this may be down to the fact that the “green shoots” identified earlier in the year, have taken root and are beginning to assume a winnowy form. We wrote at some length, last week, regarding our concerns relating to the aggressive pace at which a steeply upward sloping sovereign bond yield curve has materialised and the number of ways in which that shape can be interpreted. **What really concerns us is the fact that the demands of Labour Party back benchers are diametrically opposed to the wishes of the financial markets.** Having suffered the mother and father of all drubbings at the polls, backbenchers are feeling highly vulnerable. Were a similar result to occur at the general election the Party might come close to complete oblivion. Of course, elections such as these, following in the wake of two years of crisis and in the midst of a severe recession always provide sufficient justification for the “cauliflower ear” of protest, but were the proportionate share of the turnout to be repeated at the general election the auguries are not favourable!

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So, it appears, Mr Brown has revealed humility, a humble, caring, side to his carefully crafted craggy public persona. Back benchers apparently fell for it, or the less guileful approach adopted by the supporting praetorian guard. "We are the party that can solve these problems and the guy who's best placed to do it for us is Gordon," one high profile back bench MP is reported to have said in the wake of Monday night's meeting. The fact is that back benchers, fearful of their medium-term job security, need concessions from the prime minister which they hope might prove sufficiently alluring to the electorate to give Labour one last chance after twelve (or possibly thirteen) years in office, depending on when the election is held. The problem is that not only does the government have no wiggle room from which concessions can be wrung, but by so doing the demands of the financial markets are cast aside. Woe betide he who ignores the power of the markets! Having run up the fiscal deficit from Hell, the markets want a clear strategy for its future diminution. Simply relying on a "V" shaped recovery in economic output, particularly when so much depends on the global economy's ability (apparently) to do the same, seems to us a gigantic and desperate act of faith.

Fiscal mess

Perhaps, through a policy of benign neglect, the authorities both here and abroad are hoping that aggressive fiscal and monetary stimulus will engineer a reflation of the global economy and that a burst of inflationary pressure might go some way towards mitigating the unholy mess that the fiscal deficit has become. To recap, public borrowing emerged around £90bn over 2008-09, some £10bn higher than the Chancellor predicted at the time of the Pre-Budget Report and some 6% of Gross Domestic Product, the biggest budget deficit since 1994. If that were not bad enough conditions are set to deteriorate even further. Firstly, the full adverse effect on the public finances of the collapse in the domestic and global economy has yet to come through. Nominal GDP is forecast to be some 10% lower than the Chancellor forecast in the Pre-Budget Report by 2010-11 and by the Treasury's own calculations, this will serve to push annual borrowing up by over £100bn against the Chancellor's own forecasts.

To some extent this problem is cyclical and may be reduced when the economy revives. But there is, in addition, a growing threat that we might be witnessing a structural deterioration in the public finances reflecting permanently lower activity, income and profitability in the financial and housing sectors, to say nothing of the ultimate cost associated with measures aimed at supporting the banking sector. Public borrowing is now forecast to run at levels of £200bn a year or more over the next five years. This would have the effect of raising the level of public debt (excluding nationalised banks) to close to £1.5tr, or 100% of GDP, the highest since the post-WW2 fiscal hangover in the 1960s.

This does not, amazingly, mean that the UK is necessarily bankrupt! The country has actually survived with even higher levels of debt for long periods in the past. How sustainable the position is depends to a greater extent on the ability for both short and long-term interest rates to stay low and for the interest bill to remain manageable. In this context the recent steepening in the bond yield curve, if sustained, would be extremely concerning.

The marked deterioration in the public finances has two highly significant consequences. Firstly, it confirms the view of Bank of England governor Mr Mervyn King's assertion that there is little room for a further significant loosening of fiscal policy to boost the UK economy and second, the greater the deterioration in the public finances over the next two years, the larger and more painful the spending cuts required to sort the mess out. It goes without saying that the earlier the next general election is, the sooner the process of consolidation can begin. By stringing out the election date to the last possible moment the UK government is giving financial market investors every opportunity to vote with their feet. In the genteel language of the market strategist what this means is that overseas investors are likely to demand a higher near-term risk premium as the quid pro quo for investing in sterling denominated assets. That is, needless to say, not a good thing!

“V” shaped recovery or two-fingered salute?

As reported above, economic data releases over the past month or so have provided some evidence to suggest that the global economy may have only experienced a Great Recession rather than another Great Depression. Economic growth estimates are being nudged gently higher, for both the remainder of this year and next. The US economy may actually achieve growth of 1% over 2010, China appears (according to official data) to be growing again and India shows promise following the surprisingly strong result achieved by the Congress Party at recent elections. The eurozone is expected to report a c5% decline in output over 2009, but to achieve a partial revival over 2010 to contract by c0.5%. Based upon the significantly sub-trend outlook for growth in both the US and the eurozone, the UK's two most important trading areas, the scope for an export-led rescue mission to recover the UK's fortunes looks distinctly premature.

Let's not be too churlish. Domestic economic activity is reviving and the UK may now post a contraction in output of c-3.5% over 2009 (from -4.0% earlier). Should this partial revival be maintained we might now see the UK achieving c+0.5% growth in overall output over 2010 (from -1.0% earlier), although this febrile figure leaves much to chance. Despite the apparent recovery in stock building, following aggressive de-stocking in late 2008 and early 2009, the fact remains that household balance sheets remain deeply debt constrained, unemployment levels continue to rise and the recent mini-revival in the housing market could yet prove a mirage, particularly so given continued unwillingness on the part of the banks to extend offers to would-be buyers. Furthermore, the April Budget confirmed only the smallest of fiscal stimuli which will, over time, be replaced by the donning of an unpleasant hair shirt in the form of sharply higher taxation for many. Insofar as consumer spending accounts for around 66% of overall economic output, the prospects for an early return to trend growth look slim to say the least.

A prolonged period of sub-trend growth (at best) would limit the scope for an aggressive revival in inflationary pressure. While deflation remains the more significant near-term threat, the medium-term outlook indicates that monetary conditions are likely to remain extremely accommodative for a very considerable period of time.

Risk appetite slip sliding away

What helps to put the “Great” in “Great Recession” is the strong likelihood that this period of sub-trend growth could persist for a long time. Our best guess at the cross-section of equity market performance is that the near-term economic recovery should encourage benchmark equity indices to move higher over the second half of this year. This may provide government strategists with the underlying justification for “declaring victory” over the crisis and holding an election in the autumn of this year. We are not convinced that the continuation of this equity market revival will, on its own, be sufficient to encourage the necessary “feel good” factor amongst the broader electorate to carry the Labour Party to another victory at the polls, however, it may be the best opportunity they get.

The reason for saying that is that equity markets are leading indicators i.e. they get their retaliation in early (much as I should have at school all those years ago!). At present equity investors are giving the economic revival the benefit of the doubt, however, as time passes and it becomes more obvious that the revival is petering out into a possibly prolonged period of sub-trend growth, with negative implications for the pace at which corporate profits and cash flows improve, so sentiment is likely to wane again. Our 4900 FTSE 100 year-end forecast may yet prove to be a near-term peak.

Sterling has proved remarkably resilient on the foreign exchanges, particularly so in the context of the economic woes highlighted above. Admittedly, the UK is far from alone in suffering the fall-out from the economic and financial market turmoil but even so the pound's strength has been surprising. Inevitably, we do not expect it to last, particularly against the dollar, although we do suspect that the extent of the US economy's fiscal woes should act to ensure that the greenback remains enfeebled too.

Over in the government bond market many investors have been caught out by the speed with which medium and longer dated bonds have been sold-off. Whilst a near-term rally may be unlikely, given the economic revival apparently underway, over the medium term we believe that government bonds might stage something of a come-back. The extent of this come-back is likely to be circumscribed by aggressive bond issuance associated with central bank quantitative easing, however, the combination of anchored short-term interest rates, limited scope for break-even inflation rates to build on the rise achieved over H1 given substantial negative output gaps and finally, the depressed level of real yields, themselves a function of ultra-low short rates and concern regarding the pace of that economic recovery.

Conclusion

If the UK prime minister thinks that holding on to power and staggering through to the very end of the ruling Labour government's prescribed period of office might enhance his chances of success at the polls, our assessment of economic and financial market conditions concludes otherwise. We would agree with the assertion produced by one particular "Blairite" rebel that the longer the government hangs on, the greater the chances that the Labour Party might suffer close to complete wipe-out at the next general election. The economic omens are not good and financial market sentiment remains brittle. Better to go to the people sooner and probably better to go with a new (if equally unelected by popular mandate) man at the helm, than later with the same exhausted policy agenda.

There. The rage has abated and writing has provided the necessary closure. The writer took up yoga for a short time a while back, in an attempt to reach a state of inner calm, but gave it up quickly. There are only so many times that one can suffer the humiliation of super model Elle Macpherson's (yes, she was in my yoga group) laughter every time one falls over, which, in the writer's case, was quite a lot!

Forthcoming Key Economic Releases

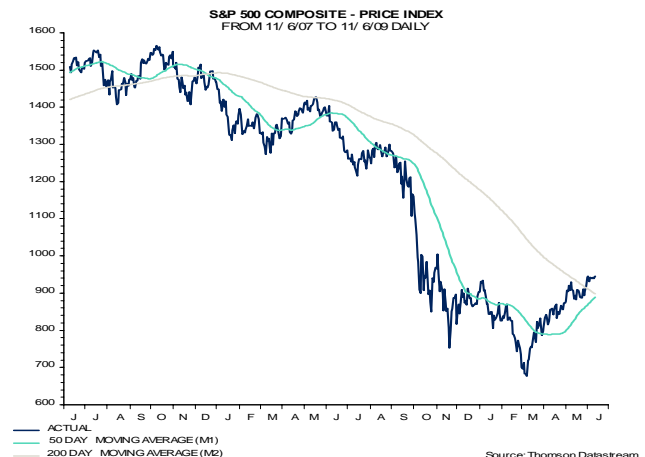
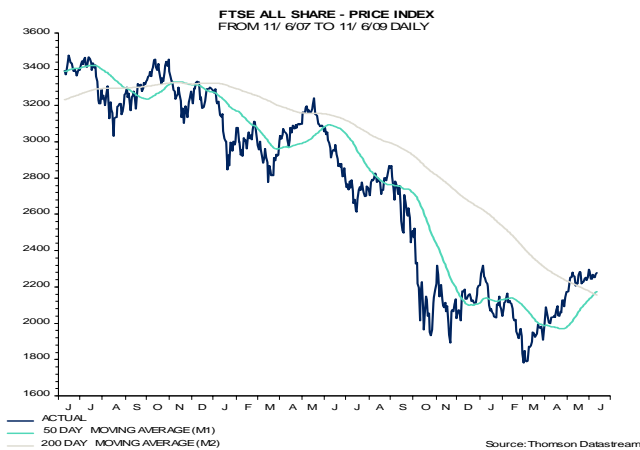
Week Beginning 6 th April 2009					
Date	Country	Event (BST)	Month	Median	Previous
Monday 15 th June	USA	Empire State Manufacturing Survey (13.30)	June	-6.00	-4.55
		NAHB Housing Market Index (18.00)	June	17	16
	Eurozone	EC Employment (q/q,y/y) (10.00)	Q1 2009		-0.3%/0.0
	Japan	Bank of Japan MPC Meeting begins			
Tuesday 16 th June	USA	PPI (m/m,y/y) (13.30)	May	+0.6%/-4.4%	+0.3%/-3.7%
		PPI ex Food & Energy (m/m,y/y) (13.30)	May	+0.1%/+3.2%	+0.1%/+0.1%
		Housing Starts (13.30)	May	480K	458K
		Building Permits (13.30)	May	500K	494K
		Industrial Production (14.15)	May	-0.9%	-0.5%
		Capacity Utilisation (14.15)	May	68.4%	69.1%
	UK	CPI (m/m,y/y) (9.30)	May	+0.3%/+1.9%	+0.2%/+2.3%
		Core CPI (y/y) (9.30)	May	+1.5%	+1.5%
		RPI (m/m,y/y) (9.30)	May	+0.2%/-1.5%	+0.1%/-1.2%
		RPI-X (y/y) (9.30)	May	+1.2%	+1.7%
	Eurozone	German ZEW Survey (Economic Sentiment) (10.00)	June	35.0	31.1
		German ZEW Survey (Current Assessment) (10.00)	June	-92.5	-92.8
		EC ZEW Survey (Economic Sentiment) (10.00)	June	30.0	28.5
		EC CPI (m/m,y/y) (10.00)	May	0.0/0.0	+0.4%/+0.6%
		EC Core CPI (y/y) (10.00)	May	+2.6%	+1.8%
Japan	EC Labour Costs (y/y) (10.00)	Q2 2009	+2.9%	+3.8%	
	Bank of Japan Target Rate	16 June	0.10%	0.10%	
Wednesday 17 th June	USA	CPI (m/m,y/y) (13.30)	May	+0.3%/-0.9%	0.0/-0.7%
		CPI ex Food & Energy (m/m,y/y) (13.30)	May	+0.1%/+1.8%	+0.3%/+1.9%
		Current Account Balance (13.30)	Q1 2009	-\$85.0bn	-\$132.8bn
	UK	Bank of England MPC Minutes (9.30)	17 Jun		
		Claimant Count Unemployment Rate (9.30)	May	4.9%	4.7%
		Jobless Claims Change (9.30)	May	63.0K	57.1K
		Average Earnings Inc Bonuses (q/q,y/y) (9.30)	Apr	+0.2%	-0.4%
		Average Earnings Ex Bonuses (q/q,y/y) (9.30)	Apr	+2.8%	+3.0%
		ILO Unemployment Rate (q/q) (9.30)	Apr	7.3%	7.1%
		Manufacturing Unit Wage Costs (q/q,y/y) (9.30)	Apr		+9.8%
	Eurozone	EC Trade Balance (10.00)	Apr	-€1.5bn	€0.4bn
		EC Construction Output (m/m,y/y) (10.00)	Apr		-1.0%/-8.7%
	Japan	Bank of Japan Monthly Report			
		Machine Tool Orders (y/y)	May (f)		-79.3%
Thursday 18 th June	USA	Weekly Jobless Claims (13.30)	13 June		601K
		Continuing Claims (13.30)	6 June		6816K
		Leading Indicators (15.00)	May	+0.9%	+1.0%
		Philadelphia Fed (15.00)	June	-18.0	-22.6
	UK	Retail Sales (m/m,y/y) (9.30)	May	+0.5%/-0.1%	+0.9%/+2.6%
		PSNCR (9.30)	May		£5.2bn
		PSNB (9.30)	May		£8.5bn
		M4 Money Supply (m/m,y/y) (9.30)	May (p)		+0.2%/+17.4%
Friday 19 th June	Eurozone	German Producer Prices (m/m,y/y) (7.00)	May	0.0/-3.6%	-1.4%/-2.7%
		French Wage Growth (q/q) (7.45)	Q1 2009 (f)	+0.8%	+0.8%
	Japan	Bank of Japan MPC Minutes for May			

Equity Index Activity

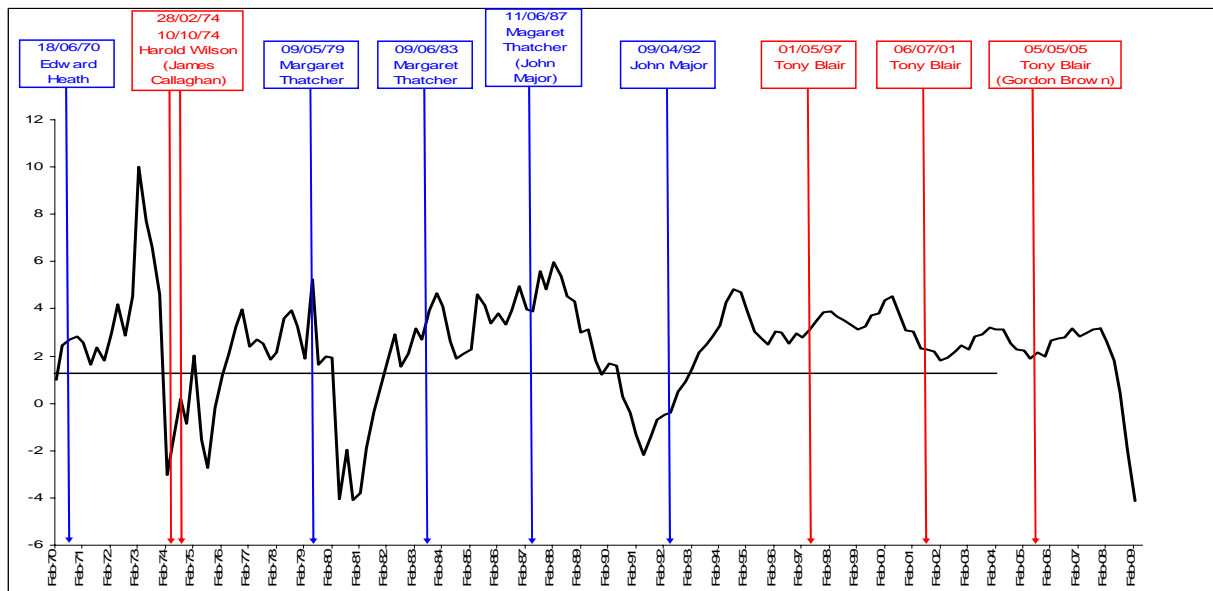
All Indices shown in home currency	Close 13-Jun-05	1 week (%)	1 month (%)	3 months (%)	Year to date (%)
FTSE 100	4461.87	1.71	0.59	1.67	0.62
FTSE MID 250	7754.44	1.23	1.89	22.69	21.91
FTSE ACTUARIES 350	2330.58	1.65	0.75	3.79	2.76
DOW JONES INDUSTRIALS	8770.92	0.24	4.18	2.40	-0.06
S&P 500 COMPOSITE	944.89	0.26	3.92	8.16	4.61
NASDAQ COMPOSITE	1862.37	0.67	7.57	23.51	18.09
NIKKEI 225 STOCK AVERAGE	9981.33	3.23	5.60	14.46	12.66
HANG SENG	18791.03	1.56	9.97	20.35	30.61
FRANCE CAC 40	3334.94	0.69	2.66	0.87	3.63
DAX 30 PERFORMANCE	5107.26	0.84	4.94	7.13	6.18
FTSE ALL-WORLD	166.85	1.10	6.27	14.86	11.85

Global Earnings Growth Estimates (%)		
Region	2009e	2010e
Europe	-16.8	+19.7
UK (FTSE 100)	-34.2	+17.8
UK (FTSE 250)	-15.2	+14.0
USA	-13.1	+28.4
Pac (ex-Japan)	+0.6	+36.1
Japan	+34.0	+17.8

Global P/E Ratios (X)		
Region	2009e	2010e
Europe	12.7	10.6
UK (FTSE 100)	13.2	11.2
UK (FTSE 250)	12.4	10.9
USA	15.8	12.3
Pac (ex-Japan)	16.9	12.4
Japan	N/A	91.2



GDP % Change Year on Year and UK Elections



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