

# HAMPSHIRE COUNTY COUNCIL

## Decision Report

<b>Panel:</b>	Pension Fund Panel
<b>Date:</b>	09 February 2010
<b>Title:</b>	Economic and Financial background
<b>Reference:</b>	1304
<b>Report From:</b>	The Independent Adviser

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### 1. Summary

- 1.1. This report considers the economic situation, and the context this sets for investment policy. It is therefore a supplement to my previous note which concentrated on the financial aspects of the international scene, and reflects the position as I see it on 27 January 2010

### 2. General

- 2.1. For the last three months virtually everyone from politicians to economists and journalists to financiers and businessmen (and even members of the general public) have been anxiously awaiting the answer to whether or not the economy grew in the final quarter of 2009. The myth has become accepted wisdom that even the merest improvement in GDP would signal that Britain had, in the unfortunate but ubiquitous phrase, had 'emerged from the mire of recession' shamefully bringing up the rear of the developed nations to do so. A rise of a mere 0.1% is therefore disappointing, but of little more real significance than any change between -0.2 and +0.5% would have been.
- 2.2. It is an extraordinary idea that the merest uptick – of a single thousandth of the national income – should carry such a weight of expectations, but, as all too often, apprehensions can obscure reality.
- 2.3. Like students re-sitting an exam they had failed, all the stops were pulled out and in a desperate lunge for the finishing line, Christmas sales in the shops battled against bitter winter weather for the upper hand.
- 2.4. This emphasised the role of the consumer in supporting the economy and generating future growth. But there must be a large question-mark over the ability – let alone the desirability – of a return to such established patterns to sustain recovery in a dramatically changing world.

- 2.5. Queuing up long before dawn to fight to buy goods that are not needed (and many of which will never be used) with borrowed money cannot make any useful contribution to healthy growth of a national economy, let alone that of the globe as a whole.
- 2.6. In the following sections I set out the dependence for renewed and balanced growth on a reduction of the dominance of immediate consumption. With a general election no more than four months over the horizon, this is not a message likely to be preached from the platforms of any of the political parties. Meanwhile we are in the position of trying to start up a car with its battery very low after another cold and frosty night. Can we keep it running?

### **3. Employment**

- 3.1. December brought the first decline in the total number of people out of work since mid-2008. Although the fall was small (7,000) leaving the figure just under 2.5m, this was greeted as a very green shoot indeed, and an indication that the recession was over.
- 3.2. Looked at more closely, the numbers seem rather less encouraging. First of all, those actually in work also fell, and by twice as much, to under 29m. Those described as 'economically inactive' went up by almost 80,000 to top 8m for the first time (mainly due to the difficulties experienced by new graduates in finding jobs).
- 3.3. Perhaps more significantly, within the total employed those with full-time jobs fell by 113,000 (mainly men) with part-time work growing by 99,000 (predominantly women). Overall, this pattern indicates that income from employment must have declined.
- 3.4. Since the beginning of the recession unemployment has risen from 5.1% to 7.8% - or about a third. But GDP dropped by 6%, including a fall of some 4.8% in 2009, the largest annual decline since 1921 (that is not a misprint).
- 3.5. It follows that productivity also fell back, which is contrary to the usual pattern of a recession in which it tends to be the less productive workers who are first to lose their jobs, thereby increasing the average output of those remaining in work.
- 3.6. In fact, this is what has occurred in the US. Unemployment there has more than doubled, to 10.0% while the economy has shrunk by no more than 3.8%. Two consequences are that productivity has therefore risen, but that at the same time those without jobs for more than a year have more than doubled.
- 3.7. The implications for the two countries are therefore also different. In the UK the relative 'hoarding' of labour means that any continuing recovery will lead to only slow expansion of employment as the existing numbers can handle a greater output. In the US sustained increases in production will translate into higher demand for labour at an earlier stage.

#### **4. Income**

- 4.1. 2010 looks like being a stagnant year as far as personal incomes are concerned. In the private sector increases will probably be held down to little more than 1%. Although public sector employees secured around 3.5% last year, this will be sharply scaled down in 2010 (with the prospect of cuts in the payroll numbers having a further impact later in the year).
- 4.2. Boosts to incomes which cushioned the immediate impact of the recession from mid-2008 to mid-2009 (such as big reductions in mortgage interest payments and petrol and fuel prices) will drop out of year-on-year comparisons and indeed be replaced by increases.
- 4.3. Taxes are also set to rise, and the end of the much-derided stimulus of the cut in VAT in late 2008 (the effectiveness of which miraculously became significant when it was reversed) is already having an impact in slowing retail sales.
- 4.4. Cuts in public expenditure will not, as has been suggested, result in a corresponding injection of spending power into private spending. Many such reductions will either force people to pay more for the affected services out of their own pockets or to cut down on other purchases. Reduced 'bus subsidies; higher prescription charges; increased fees and charges for some local authority services, and various licences are obvious examples.
- 4.5. If inflation settles down to average anything much over 1.5% for the full year, real incomes will struggle to keep pace. Should the current trend for people to pay down existing debt and increase their savings rate continue, there would then certainly be a reduction in current private consumption.
- 4.6. That would not be regrettable, as it is one of the prime requirements for the necessary rebalancing of the economy in the medium term.

#### **5. Investment**

- 5.1. While it is becoming conventional wisdom that this country needs to increase both the amount of money and the share of GDP going into investment, a major determining factor remains the effective demand for such spending. This in turn depends on the adequacy, or otherwise, of the existing capital stock.
- 5.2. There is considerable dispute as to the extent of spare capacity of plant taken out of use as a result of the recession or running at a reduced rate. It is likely that much of this capacity will not be brought back into use, either because the pattern of demand has altered or because it has become ineffective.
- 5.3. Indications are that much of industry has only limited plans for capital investment on a sustainable scale over the next few years, although many companies have taken the advantage of low interest rates to raise or earmark new capital (or restructure existing debt more cheaply) and therefore have stockpiled ammunition for the future.

- 5.4. However, and in spite of the regular drum roll of complaints that the 'banks are not lending' this has mainly affected smaller businesses as the banks have become prudently more cautious about the degree of risk they incur (in line with other contradictory urgings from the Government).
- 5.5. Even while larger organisations have been able to tap non-bank sources of funds, the net total of new money raised by UK business last year was negative. This does not suggest that there is a pent-up wave of new investment just waiting to be released once the recession can be pronounced to be definitively dead.
- 5.6. This seems to point to the public sector, and the county's infrastructure, as the most likely area for major capital investment. That would favour potential contractors to public authorities as beneficiaries – together with a possible revival in house building for public bodies if the open housing market continues to find conditions difficult.<sup>1</sup>

## **6. Inflation**

- 6.1. Headline stories about 'soaring' inflation in December led to fears of a sustained surge in prices triggering a premature rise in interest rates, and the danger of throttling the recovery before it has really started.
- 6.2. This was the result of the increasingly common practice of comparing statistics like the inflation figures on the basis of how they have changed over a 12 month period instead of on a continuing month on month trend.
- 6.3. Thus, to be told that the Consumer Price Index rose by 2.9% in December (and that the wider Retail Price Index went up 2.4%) simply tells us that these were the increases over December 2008 – and ignores what may have happened in more recent months.
- 6.4. In fact, both indices actually fell between the two Decembers: the RPI from 216.0 to 212.9 and the CPI from 109.9 to 109.5. Between November and December 2009 the RPI both rose by 0.7% - quite a lot for one month, but well below inflation impressions given by the way the figures were widely presented.
- 6.5. In assessing inflation over the rest of the year, it is as well to watch monthly change as well as the year-on-year comparison. Even should prices rise faster than the official 2% target on CPI, it would be a mistake to conclude that this makes a case for accelerating increases in interest rates.
- 6.6. Given that incomes are likely to be more or less static in real terms, price rises in themselves would then be actually deflationary as they would reduce effective purchasing power. There would be no need - indeed it could be positively dangerous – to overreact by reinforcing this by further depressing demand.

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<sup>1</sup> See figure 8 in Appendix 1

## **7. Deficit**

- 7.1. The main division of opinion between both politicians and economists is the rate at which the Government's financial deficit should be reduced. This is also closely linked to questions about the future course of interest rates and the winding down of the so called quantitative easing process.
- 7.2. To some extent the widespread horror at the thought of a deficit running at around 85% of GDP is simply due to the contrast with the former target of 40% laid down at the start of the present Government's first term of office. This was a purely arbitrary figure conjured up out of thin air, and overlooking the fact that many developed countries had been running larger deficits as a matter of course and without adverse consequences for many years.
- 7.3. In practice it is the cost of financing the deficit rather than the size of the debt that needs to be considered. Indeed, the cost to the public purse of financing debt of 85% of GDP at, say, 1%, is less than the cost in past years of paying 3% on obligations of 40% of GDP.
- 7.4. It is widely expected that the Bank of England will leave its own interest rate at or close to the current level of 0.5% for most of this year, and possibly into 2011. In that case, it might seem to follow that there is no great urgency to accelerate the running down of the deficit.
- 7.5. However, low interest rates are only one of the two crutches on which the economy now relies for support. The other is the massive sum of £2,000 billion piled up in the quantitative easing programme which has seen the Bank build up holdings of gilt-edged stock equivalent to about a quarter of all the short-dated stock in issue. This is going to have to be fed back into the markets, probably in steady instalments over the rest of this year into next.
- 7.6. This must prove highly indigestible. While all kinds of ingenious arrangements will be devised to persuade private sector buyers to swallow successive doses of these securities, inevitably spoiling their appetite for other kinds of investment, it will also and more seriously, put upward pressure on interest rates quite apart from any considerations of countering possible emergence of sustained rises in inflation.
- 7.7. While the deficit itself may be reduced by some of the securities that have been pledged to the Bank turning out to be eventually worth more than their current book value, the process of winding up QE may well exercise a depressing impact on the economy that outruns the limited stimulus of hesitant recovery.
- 7.8. While the UK deficit, treated on its own, is therefore probably a smaller headache than is generally assumed, there is a potential problem in the fact that many other countries will be in the markets as borrowers attempting to finance, or refinance, their own debt. This could certainly put serious pressure on the ability to secure the required sums without a competitive forcing up of interest rates.

- 7.9. The UK, along with the US, is most at risk because they continue to run large foreign trade deficits, although the former has been reducing its gap while the UK is living mainly in hope.
- 7.10. The difficulty is that for as long as the surplus countries (primarily China, Japan together with some Middle Eastern oil producers and, to a lesser extent, Germany) continue to increase exports and pile up a glut of savings in consequence, it will be difficult to stop running up debt in the UK and US faster than income rises in the possibly extended period before recovery becomes fully-fledged. The US can stay in this skin game longer than we can partly owing to the strength of the dollar as the main reserve currency and (flipside of that) its continuing peg to the Chinese renminbi.
- 7.11. Keynes has been fairly successfully resuscitated to point the way to keep national economies functioning by pumping up support from public sector finance while the private sector recuperates. But his ghost is now needed to perform the same function on the incomparably more complex international scene.

## **8. Trade**

- 8.1. For almost all of the period since 1970 international trade has regularly expanded faster than world GDP as a whole.
- 8.2. Between 2004 and mid-2008 the volume of world trade grew by almost 50%. Last year it fell back by half of that increase and cancelled out all its gains since 2005<sup>2</sup>.
- 8.3. It is to be expected that trade will resume its leading role as and when the global economy stabilises and expands again.
- 8.4. However, just as the level of consumption within Britain needs to be rebalanced so too does Britain's relative role within the world economy.
- 8.5. The increase in both the size and population of the large emerging countries, as well as their faster pace of development, means that Britain's own growth must in future be slower than the overall average. That also means that unless global GDP settles down to a pace of expansion faster than prevailed before the Great Recession (as we now seem supposed to label the past two years) our future rate of growth must be less than we were achieving then.
- 8.6. Even to secure that modest target will be difficult and it is quite clear that it will depend very largely on a buoyant export performance. The main obstacle to this, and which may prove persistent, is the extent to which the main surplus trading nations, Japan and Germany, continue to regard their export industries as the main focus of their economic strategy, but it is simply not the case that a stable structure of international trade can be preserved as long as the current lop-sided distribution of exporters and

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<sup>2</sup> See figures 4 and 5 in Appendix 1

importers persists – not least because of the uncontrollable currency distortions that this must eventually produce.

- 8.7. Although it has been widely assumed that British exports will benefit from a fall in the value of sterling, there has been little sign of such an effect so far. In fact, against the dollar, the pound has recovered 20% from its low point in 2009 after dropping 40% from its peak of just over \$2,10. This means that import prices for raw materials remain high.
- 8.8. Success in export markets will depend increasingly on the sophisticated end of manufacturing, together with continuing strong performance in the whole range of financial and other services – including a subdued bank sector.

## **9. Summary**

- 9.1. To achieve a new equilibrium from which the British economy can hope to follow a course of steady but reliable progress, there are three key requirements.
- 9.2. I set these out below, together with my own subjective estimates of their chances of being met.

1. **Acceptance of a smaller role for current personal consumption**

This is currently being forced upon us by events. Chance of success: 6/10.

2. **Increased investment, particularly in infrastructure**

There are problems in raising sufficient finance. Chance of success: 4/10

3. **Increase share of GDP exported to at least main current world share**

Very largely beyond our control. Chances of success: 2/10

## **10. The current investment scene**

- 10.1. Markets entered the New Year feeling generally rather apprehensive, as if they were looking for an excuse to hesitate after the unexpected surge of most markets in most things since the spring of 2009.
- 10.2. President Obama duly provided the pretext when he unveiled his multi-pronged assault on American banks.
- 10.3. In retrospect, 2009 was a year in which appetite for risk re-emerged under the pressure of sustained and abnormally low rates of interest. The basic question which may be answered in the first half of this year is whether or not the recovery in share, property, and commodity prices has simply fed on itself, creating the thread of another series of bubbles as it outruns economic recovery around the world, or whether that recovery still has momentum.

- 10.4. In any event, there is a clear division between the developed and emerging nations in the strength of prospective growth. Even though they account for a sharply rising proportion of world economy, emerging nations, with China at their head, still make up only a small share of global activity.
- 10.5. China itself, with its sustained rate of GDP consistently close to an annual 10%, only accounts for around 7% of world output – one-third of the American contribution – and yet it has 20% of the world's population.
- 10.6. Great hopes are held of a switch in the balance of the Chinese economy towards greater emphasis on private consumption at the expense of its own exports, and a shift in that direction is becoming visible: the Chinese market for cars took more vehicles last year than America.
- 10.7. But, although this trend helped to ward off a deeper dip globally in 2009, the task of sustaining this pace is illustrated by the relative size of consumer spending in the world's two largest economies.
- 10.8. In the US private consumption absorbs two-thirds of GDP of some \$15 trillion, shared by some 310 million people. In China the population of 1,350 million spends on consumption \$2 trillion, or just under 40% of total GDP.
- 10.9. That means that a 1% increase in consumption in the US contributes over seven times as much global growth as a 1% improvement in Chinese spending.
- 10.10. Nevertheless, investors have been channelling an increasing share of their funds to the emerging markets and this shift of emphasis seems far from complete.
- 10.11. The rush to invest in the newly developing economies runs the risk of proving indiscriminate – in the same way as investors came a painful cropper 20 years ago by putting ridiculous premiums on small companies with no background or record, provided only that the magic words 'dot-com' were mentioned in their prospectuses.
- 10.12. A warning sign is the appearance of a multiplicity of new funds claiming specialist knowledge of some (or in certain cases, most) emerging markets. At the same time, selecting individual companies for investment is open to the risk that imperfect knowledge of the wider markets in which they operate can lead to their shares being overbought simply because of familiarity. As has been well said, why is everybody piling into the big Brazilian oil company Petrobras as new discoveries and prospects of more are announced, instead of seeking out the makers of drilling equipment and providers of services to the oil industry?
- 10.13. Careful selection, rather than GDP growth figures, must be the key to sustained successful investment in these lesser known markets.
- 10.14. Closer to home, the FT main index has been proceeding more cautiously in the most recent months, establishing successive 'base camps' at around

5,000 and then 5,200<sup>3</sup>. There seems to be reasonable support at each of these levels, with the downside probably limited as a result. It remains to be seen whether the sudden attack of nerves in the last week of January seriously tests these supports, but a fall below 5,000 would be serious.

- 10.15. Sitting on fences is normally an unrewarding and uncomfortable activity. But while two dilemmas slowly resolve themselves, it may also be relatively safe.
- 10.16. The first is whether the unravelling of the huge commitment of public finance to supporting the economy will lead to inflation or deflation. In my own view, such unwinding needs to be steady and gradual rather than rapid, and in that case the effect should be virtually neutral, with the important proviso that in practice the pace needs to match that of incipient recovery. Inflation is not a serious risk, particularly if certain rising costs are not classified as inflationary – which they should not be if they do not trigger attempts to offset them by conceding the kind of increases in incomes that start a true inflationary spiral.
- 10.17. The second dilemma is the Chinese puzzle. While that country's contribution seems set to ensure that global GDP growth as a whole reaches an acceptable level (3-4%) this year, the distribution of that growth may be so distorted where the pattern of exports and imports is concerned as to put serious stress on currencies and the internal balance of several major countries – including China itself.
- 10.18. Continuing Chinese emphasis on investment and exports show signs of leading to serious overcapacity in a number of heavy industries, with wasteful deployment of capital, and signs of overheating have already led to tightening monetary conditions and to the first of what may prove a series of increases in interest rates. A financial bubble bursting later in the year and a breakdown in the renewed expansion of world trade are both spectrally lurking in the background.
- 10.19. As one observer has presciently commented, 2010 will prove a year of attempting to navigate between Scylla and Charybdis: interest rates will probably remain low, which, in itself, must be welcome. But is the reason for central banks keeping them low because economies are seen as still fragile (in which case profits, dividends and share prices will also stay low)? Or are they underestimating the strength of continuing recovery, which must bring in its wake large increases in bond yields?
- 10.20. Meanwhile, a curious position has developed in property markets. Prices of commercial properties have rebounded very sharply from low points (which may well have been exaggerated). But the upsurge in values of offices and retail units seems odd, given the far from brilliant prospects for employment and shops sales over the next year or two. A partial explanation may be that while the banks still have enormous loans to property companies on their books (which they are condemned to hold on

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<sup>3</sup> See figures 1, 2 and 3 in Appendix 1.

to rather than crystallise similarly enormous losses) they are now feeling rather more optimistic about eventually recovering more money than they were expecting to last year. But plugging into this market now may be only for the very brave.

10.21. CORPORATE OR LEGAL INFORMATION:

**Links to the Corporate Strategy**

**This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision to accept the comments of the Independent Adviser.**

**Section 100 D - Local Government Act 1972 - background documents**

**The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)**

Document

Location

None

## **IMPACT ASSESSMENTS:**

### **1. Equalities Impact Assessment:**

- 1.1. Equality objectives are not considered to be adversely affected by the proposals in this report.

### **2. Impact on Crime and Disorder:**

- 2.1. The proposals in this report are not considered to have any direct impact upon the prevention of crime.

### **3. Climate Change:**

- a) How does what is being proposed impact on our carbon footprint / energy consumption?

No specific impact.

- b) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific impact.

The following selection of charts may prove useful and of some interest. Charts are widely used by some analysts as predictive guides, based on the belief that certain patterns that repeat themselves indicate probable movements in markets or other statistical series.

While I do not believe that charts actually have power to forecast the future, to an extent that there is a tendency for them to influence behaviour, there is an element of self-validation.

Thus, the fact that shares may trade within the upper and lower limits of what is called a 'channel'. Is not because of some mysterious necromantic power, but due to the fact that traders noticing the beginning of such a channel may well buy and sell as the lower and upper limits are approached.

Similarly, shares often come up against 'resistance' to a further rise, or 'support' repeatedly cushioning a fall at a certain price level. Very often a share will stage a smart upward movement after failing to fall through a previous low two or three times – what is known as a double (or treble) bottom.

The accompanying charts suggest, in some cases, where a turning point may have a good chance of occurring, and I make a few comments on these below. But while it is prudent to see what the charts are saying, action should not be determined by their shape as some enthusiasts insist. Interpretation is not always a straight forward matter.

It is as well to remember that:

*A trend is a trend is a trend  
So why should it alter or bend?  
But the wise analyst knows  
That the further it goes  
The nearer it is to its end*

**Figure 1** suggest that the FTSE 100 faces a test during February: The rising trading channel requires the lower (support) level to be at about 5300 towards the end of the month if it is not to fall below it. Should it fail to hold that level, a fairly sharp fall could occur as the next level of support is at 5200.

**Figures 2 and 3** show the position in close up. The index fell below 5400 with little or not protest, but having possible support at 5200 after bouncing back from there five times in November-December. But if that fails to hold the next stop is 5000.

**Figures 4, 5 and 6** are illustrative rather than predictive, but **figure 7** suggests that oil prices are likely to stay within the \$70-75 range for some time.

**Figure 9** challenges accepted wisdom about probable weakness of sterling. It broke a downtrend with repeated lows at just under \$1.60 and could test the double high of \$1.64 in the next six weeks. (This is not one bet I would invest big money in!)

**Figure 10** indicates that the Dow Jones is at what may be a critical point as it is testing the support line of the upward channel for the fifth time in six months. If it falls through that line support may only be found quite a long way down.

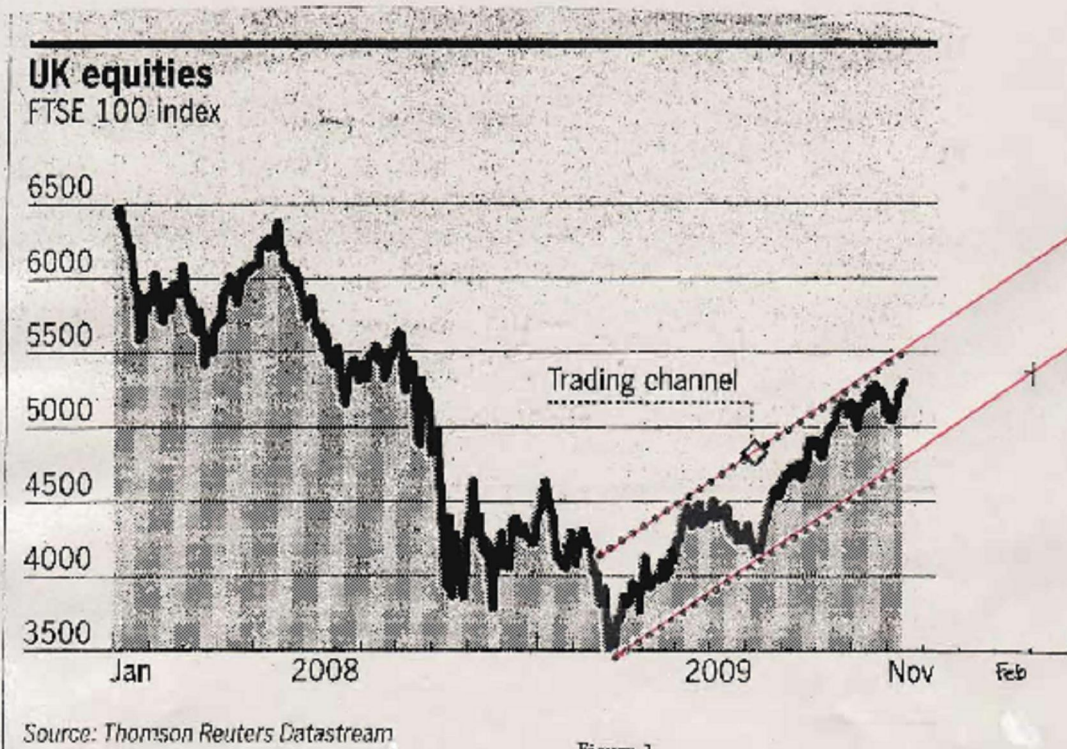


Figure 1

### FTSE 100 index

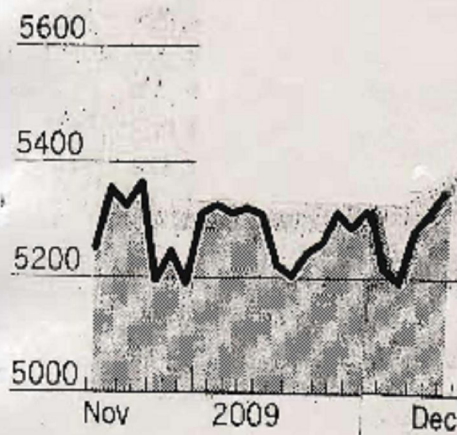


Figure 2

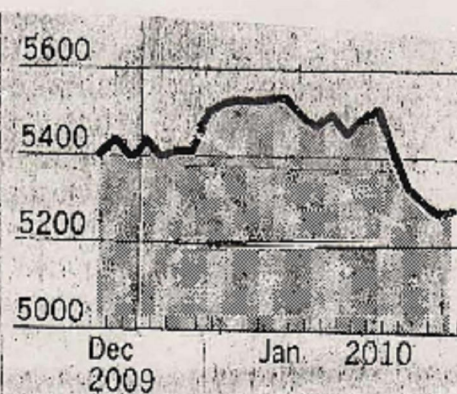


Figure 3

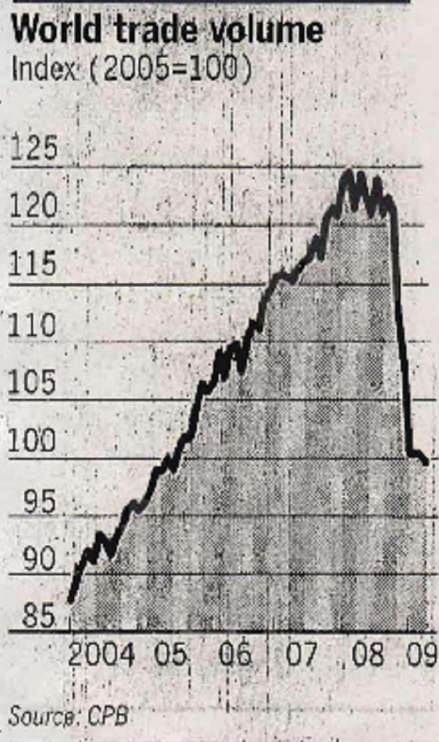


Figure 4

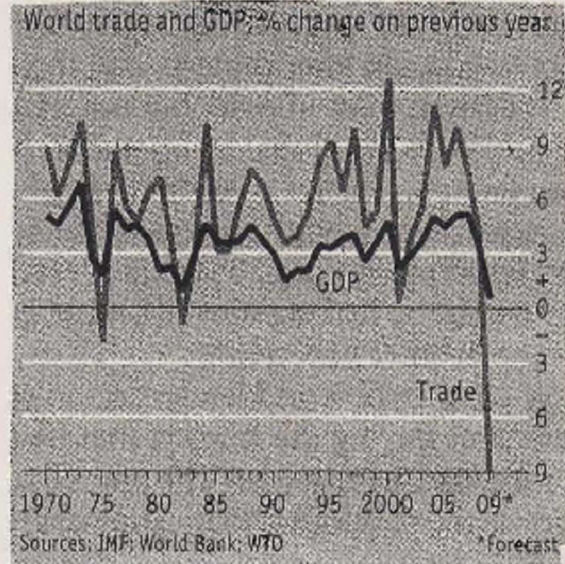


Figure 5



Figure 6

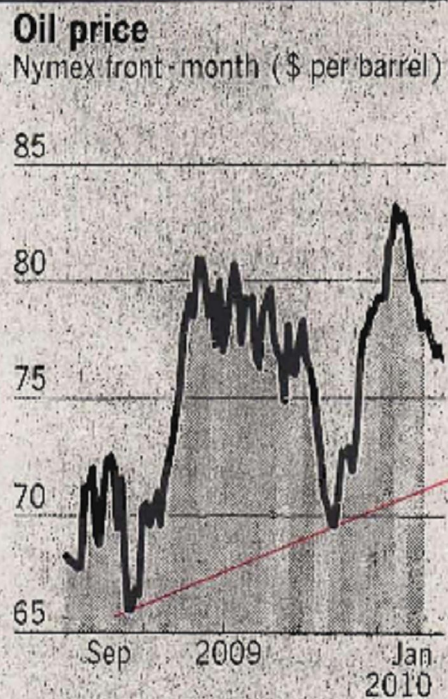


Figure 7

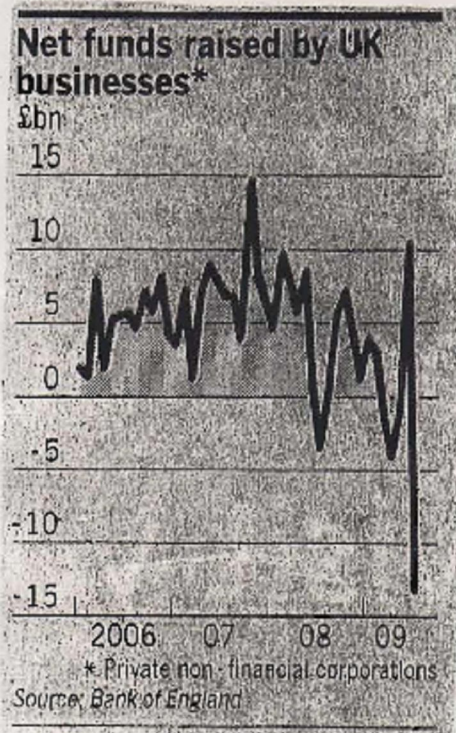


Figure 8

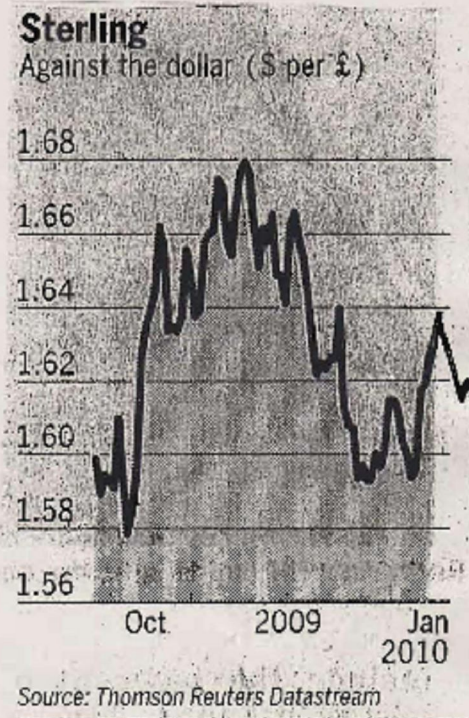


Figure 9

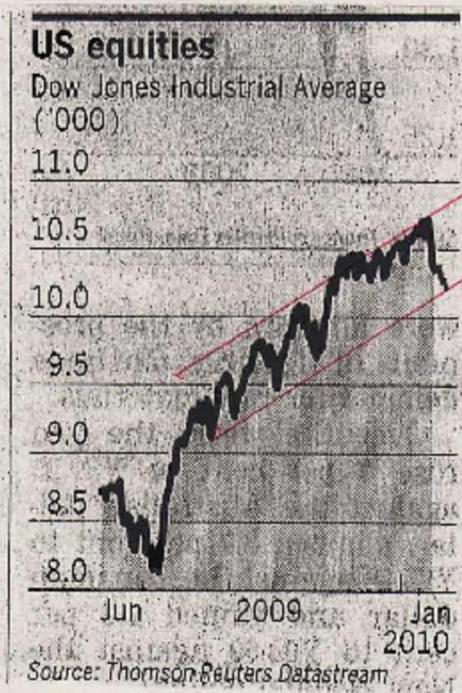


Figure 10