

Novus Capital Markets Research

Markets, Schmarkets

11 August 2011

What are the markets telling us? I have always found financial markets difficult, at times unfathomable. Analysing the economy is relatively straightforward but trying to explain what the markets have done even after the event is often beyond me. I can do the FTSE on a daily basis (it just follows the US) but what has driven the US roller-coaster ride of the last two weeks? All of the explanations make sense but they are all *ex post* – fears about a renewed downturn, changing attitudes to risk and so on. Bond markets seem more amenable to economic analysis (though answering an exam question on why 10-year gilt yields are 2.5% when inflation is heading to 5% and we have £169bn to sell would be tricky – supply and demand, dear boy). F/x markets can't be too irrational since they have given us the exchange rate we need to promote the longer-term restructuring of the UK economy but why, Mrs Dicks asks, given the problems of the euro area economy, is the euro still relatively strong? More fundamentally, are the markets telling us anything? Probably only that it is August and in thin summer trading movements are exaggerated far beyond what the news can reasonably justify.

Whatever happened to Gordon Brown's New Deal? In a week in which the youth of England has not displayed its better qualities I am reminded of Gordon Brown's first Budget (July 1997) which levied a one-off windfall tax on the recently privatised utility companies and used the proceeds to fund a welfare-to-work programme aimed at getting the young and long-term unemployed into work. Specifically unemployment was not to be an option – signing on meant signing on for work or, failing that, training or voluntary work or an environmental task force. Today, with the unemployment rate for 16-17 year old males running close to 40% and at 20% for 18-24 year olds, we have 900,000 young people who are unemployed. And we know that the devil makes work for idle hands.

Novus Capital Markets Ltd, 29/30 Cornhill, London EC3V 3NF

www.novus-cap.com or, for a direct link to the blog, <http://www.novus-cap.com/latestnews.html>

Economist: Geoffrey Dicks (+44 (0) 20 7107 1878); **Institutional Sales:** Peter Bartlett, Neill Flack (+44 (0) 20 7107 1888)

Novus Capital Markets Ltd is authorised and regulated by the Financial Services Authority. Member of London Stock Exchange plc. Please see analyst certification and important disclosures at the end of this report.

Markets, Schmarkets

Strange as it may sound, coming from someone who has worked in the City for most of the last 18 years, I have never been very interested in financial markets. The economy is an enduring passion – I’ve been commenting on, writing about and forecasting the UK economy for 35 years – but financial markets remain for me at least an unfathomable mystery. Trying to explain what often seems irrational and inexplicable has always seemed to be a particularly fruitless task. (I suspect that many City economists have the same view.)

I find equity markets particularly intractable. On a daily basis it’s quite straightforward – every market takes its cue from the US. FTSE opens where the US left off the previous night (Asia and Europe having already done the same), then spends most of the morning with its eye on US equity futures, trying to anticipate where Wall Street will open. Once the US is open, FTSE just follows suit. (This may not be unreasonable since a large part of FTSE earnings are derived from overseas activity.)

That is exactly what has been happening this week. Equity markets worldwide sold off heavily on Monday following S&P’s downgrade of the US over the weekend (the US bond market rose). This continued on Tuesday in Asia and Europe –in the morning FTSE fell below the 5000 level, hitting new 13-month lows – but was reversed in the afternoon when Wall Street rose strongly in anticipation of some soothing words from the Fed. By the close FTSE was up nearly 100 points or 1.9% at 5165. The FTSE rally continued into Wednesday morning as it took on board where the Dow had finished up the previous night (+430 points, nearly 4%) but fell back in the afternoon after the Dow had opened and in quick time had reversed all the previous day’s gains.

But what drives the Dow? Or, since FTSE and the Dow do diverge over the medium term, what drives equity markets beyond the day to day? I’m sure equity market strategists have all sorts of valuation tools based on expected future earnings which in turn are probably derived from a forecast for the global economy. But that gets nowhere near explaining the volatility of equity markets over the last week or so. At that stage we seem to have to revert to the old favourites (worries about a double dip,

fear and greed, changing attitude to risk, chart points, program trades, etc). What the cynic in me can't help but notice is that these can point one way in the morning but the opposite way in the afternoon. Ah but that's because of new information, you tell me, and of course financial markets are always reacting to new information, though quite how you can favour riskier assets one day and not the next is beyond me.

I have more respect for the f/x market since it has at least given us the exchange rate we need to rebalance the economy and promote long-term structural adjustment away from debt-fuelled consumption towards investment and net exports. And in the long-term, unless you are locked into a currency union (and, as David Cameron said, Thank God, we aren't), the exchange rate will reflect relative prices and the underlying competitive position of the economy.

But on a day-to-day basis the f/x markets are fickle. Over the years the prime movers of the f/x markets have switched between the balance of payments, growth, inflation and interest rates. Some days currencies are marked up on strong growth data, which are thought to herald a rise in interest rates; other days they worry that strong growth will lead to higher inflation and require a lower currency to maintain competitiveness. To the layman it is remarkable that, for all the problems that beset the euro area, the currency remains relatively robust. I can only rationalise that by the fact that the currency is regarded as a German bet and insurance can be taken out against the weaker economies of the periphery in the bond markets. Mrs Dicks was not convinced by this – no doubt the currency strategists have their own (better) explanations.

In theory government bond markets are more amenable to economic analysis. The price of the bond and its yield bear a simple inverse relationship. The yield is nominal, fixed for a given period of time. Inflation will erode that yield in real terms. So the higher inflation is expected to be, the higher the nominal yield will have to be to compensate for the inflation loss.

All very straightforward: so why are 10-year gilt yields at 2.5% when inflation is rising to 5% and not expected to fall to the 2% target for another 18 months? Answer: supply and demand. Ok, so why, given we are issuing £169bn of new gilts this year, are yields so much lower than say 10 years ago when the budget was in surplus and the DMO was having to resort to debt buy-backs? That must be because gilts are seen as a safe haven. And of course the market is so much more liquid than it used to be which makes it easier to transact.

Well all I can say is that I'm not convinced. Markets seem to have a mind of their own, which is largely driven by the herd mentality. On a daily basis the reasons offered by strategists for what has been going on in their market seem largely *ex post* and different from one day to the next. Markets are more/less comfortable with risk; they are revising up/down their outlook for growth/inflation/the budget deficit – you name it.

So how, you might ask, can you be interested in the economy but not financial markets? Surely what goes on in financial markets is a major determinant of future economic activity. Aren't stock markets supposed to tell us something about economic activity 1-2 years into the future? Up to a point, Lord Copper, or, as Paul Samuelson famously observed, the US stock market 'has predicted nine of the last five recessions'. That is not to say that there is no chance of another down leg in this economic cycle, only that the stock market is probably the last place I would look for confirmation of it.

Whatever happened to Gordon Brown's New Deal?

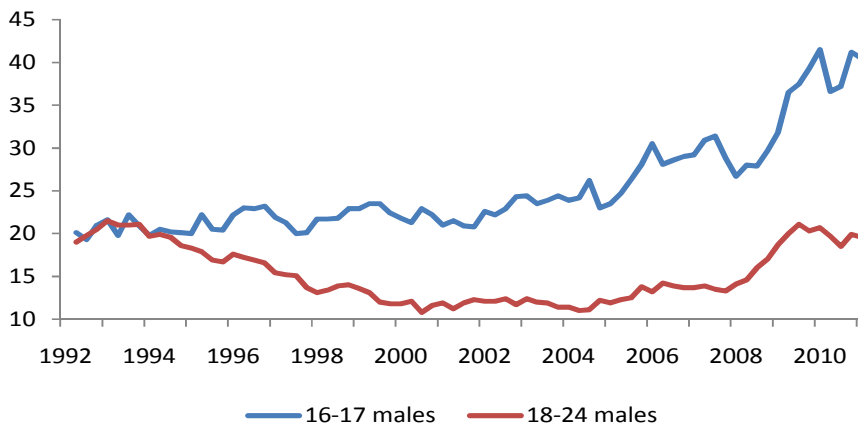
In a week in which the youth of England has not displayed its better qualities, it is worth reminding ourselves that in Gordon Brown's first Budget (2 July 1997) we had a windfall tax on the privatised utility companies specifically to fund a welfare-to-work programme aimed at helping the young and long-term unemployed back into work.

The theme of the welfare-to-work programme was that unemployment was not to be an option. Young people could remain in full-time education or they could get a job. If not, there were training schemes, work with a voluntary organisation or work on the environmental task force. But to quote the 1997

Budget speech: ‘With these new opportunities for young people come new responsibilities. There will be no fifth option - to stay at home on full benefit. So when they sign on for benefit they will be signing up for work. Benefits will be cut if young people refuse to take up the opportunities’.

At the time of the 1997 Budget unemployment was steady at about 20% for male youths aged 16-17 and at about 15% and falling for men aged 18-24. Whether it was the contribution of the New Deal or whether the product of 15 years of steady economic growth, the unemployment rate for 18-24 year olds fell steadily until the onset of the financial crisis and the ensuing recession (the rate for 16-17 year olds was fairly steady). Since then unemployment rates have shot up to 40% for the younger and 20% for the older age group (Chart 1).

Chart 1: Unemployment (%)

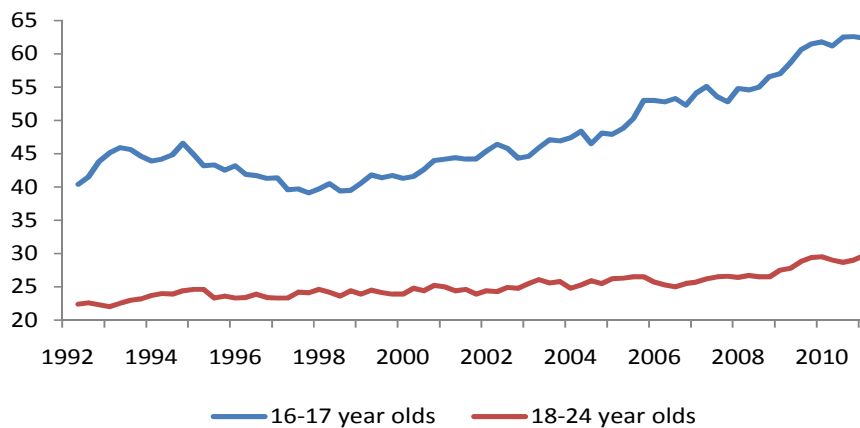


Source: ONS

Part of the increase is technical since the unemployment rate is expressed as a percentage of the active labour force (employed + unemployed). The active labour force has fallen steadily as a proportion of the age group as more young people have opted to stay in education – the number of the inactive has risen to over 60% for 16-17 year olds and to nearly 30% for 18-24 year olds (Chart 2). As a result, the proportion of young unemployed (expressed as a percentage of the whole population) has risen a lot

more slowly than the unemployment rate. (A podcast giving more background on this analysis is available on the ONS Youtube channel – www.youtube.com/onsstats – I kid you not, and we are supposed to be cutting public spending).

Chart 2: Inactivity rates (%)



Source: ONS

Even so, it is worth asking why and how over 900,000 young people in the latest Labour Force Survey have slipped through the net into unemployment. This was not supposed to be an option. They have left school (ie opted out of higher education) and they haven't got a job. They are not supposed to be doing nothing; they are certainly not supposed to be rioting and looting on the streets of our cities.

Disclaimer

The information in this report has been prepared by Novus Capital Markets Ltd. (NCM). Materials available herein have no regard to the specific business objectives, financial situation or particular needs of any specific recipient. The research is published for information purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments.

The opinions, estimates and projections in this report reflect the current judgment and express views of the author as at the date of the report. They do not necessarily reflect the opinions of NCM and are subject to change without notice.

Unless specifically stated otherwise, all price information is indicative only. No representation or warranty, either expressed or implied, is provided in relation to the accuracy, completeness or reliability of the materials, nor are they a complete statement of the securities, markets or development referred to herein. The material should not be regarded by recipients as a substitute for the exercise of their own judgment.

The financial instruments discussed in this report may not be suitable for all investors. Investors must make their own investment decisions using their own independent advisors as appropriate. The value of, and the income produced by, financial instruments may fluctuate, so that investors may get back less than they invested. A change in the exchange rate may adversely affect the value of, or the income derived from, financial instruments. Past performance does not guarantee future performance.

The analyst(s) responsible for covering the securities in this report receive compensation based upon, among other factors, the overall profitability of NCM which may, from time to time, perform corporate finance or other services for, or solicit corporate finance or other business from any company mentioned in this report.

NCM, its directors, employees and agents accept no liability whatsoever for any loss or damage of any kind arising out of the use of all or part of these materials. No part of this document may be reproduced in any manner without the written permission of NCM. The information in this report is provided with the understanding that NCM is not acting in a fiduciary capacity.

Certain laws and regulations impose liabilities which cannot be disclaimed. This disclaimer shall in no way constitute a waiver or limitation of any rights a person may have under such laws and/or regulations. NCM is authorised and regulated by the Financial Services Authority.

Copyright © 2011 Novus Capital Markets, all rights reserved. Additional information is available upon request.

Novus Capital Markets Limited, 29-30 Cornhill, London. EC3V 3NF.

Tel: +44 (020) 7107 1850 Fax: +44 (020) 7107 1851. Website: www.novus-cap.com