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Lacomp plc is an independent investment management company providing portfolio management services to private investors worldwide.

The Markets, the Economy and a General Election

Following last year's sharp rally in equities, stock markets continued to post largely positive gains in the year to date. The Far East has been rather disappointing, registering minus 1.9% in Hong Kong and a positive, albeit small return of 3.8% in Japan's Nikkei Dow index. The Dow Jones Euro Stoxx50 fell by 2.3%, whilst the other major markets did rather better: America's S&P 500 is up 8.4%, and the FTSE 100 is up 4.7%. Overall, the MSCI World index managed 4.3%, and our own CF Lacomp World Fund is up 6.6%.

What is fascinating at present is the diversity of opinions about the outlook for equities held by well known and acknowledged experts. Although one always hears some contrarian views expressed, it is quite rare that one has difficulty in finding a consensus. Now is such a time, and I think there will be many market commentators who will be forced, before too long, to make "adjustments" to their predictions!

We at Lacomp stick with our long-held view that we are seeing a real power shift in the global economy. In fact, in our Winter Newsletter of 2004, we talked at length about the emergence of China as a real economic force, and the intervening years have proven us right. Even earlier, we also had been slightly sceptical about the long term outlook for the established Western economies, contrasting them to the "Emerging Markets" by rather cheekily calling them the "Submerging Markets". Little did we realise at that time that we would encounter a large number of massive corporate frauds and scandals in the Western world, to be topped by the recent credit crunch and a banking crisis that have brought about the worst recession since the Great Depression which followed the Wall Street Crash of 1929.

Indeed, we now talk in glowing terms about the achievements of the so-called BRIC countries (Brazil, Russia, India and China) whilst Portugal, Italy, Ireland, Greece and Spain have been called PIGS countries (or PIIGS, to give them the proper acronym), a rather unkind name which nevertheless epitomizes the economic mess they are in. China is now Brazil's biggest trading partner, whilst the UK, for example, exports four times more to Spain than to any of the individual BRIC countries. Another stark contrast: whereas current GDP growth in Western economies is barely visible, China's GDP growth in the first quarter of 2010 was 11.9%! Brazil, Russia and India predict 2010 GDP growth rates of 6%, 5% and 9% respectively.

Of course, economic activity does not necessarily translate into stock market performance. Investor sentiment and the weight and/or flow of money are prime movers of these markets' indices, but clients should not be surprised to gradually see more exposure to BRIC countries and other Emerging Markets in their portfolios.

What about fixed interest investments? Whilst corporate bonds and Emerging Markets debt continue to do well, UK gilts have been disappointing: the FTSE All Gilt index has fallen 0.4% so far this year, and the outlook for gilts remains rather gloomy. Much will depend on the outcome of the General Election or, to be more specific, a potential downgrading by the rating agencies of the UK's cherished triple-A credit rating status. If UK plc were to lose its coveted top rating, it would make it much more difficult and more expensive for the Treasury to raise money, particularly from foreign investors who traditionally hold about a third of our gilts. Higher interest rates later this year in order to attract investors would be almost inevitable, which will be bad news for borrowers of any kind, be that the government, businesses or ordinary people. Add to that the very real possibility of a further weakening in sterling, and it all points towards higher gilt yields with the corresponding value erosion of the underlying assets.

We only need to look at the Greek situation, where a gradual derating over the last few months from A- to BBB- has had serious repercussions. Admittedly, a BBB- credit rating is just one notch above that of speculative junk bonds, but Greece's finances were in such a parlous state that the rest of the eurozone had to mount a rescue operation by making available some 30 billion euros, to which the International Monetary Fund is expected to add another 10 billion. Most of the eurozone money will come from Germany, followed by France and Italy. It will be interesting to see how this resonates with the people (read electorate!) of those countries, none of which are without their own problems.

The UK's predicament is dangerous, yet quite simple: With a huge existing government debt and a massive budget deficit, our ever-burgeoning overall indebtedness could spiral out of control. The incumbent Labour Government believes that continued public spending in the short term is essential to stay clear of a potential double-dip recession, taking the view that even an increased overall indebtedness will be manageable. The Tories, on the other hand, want to start cutting public expenditure right away, believing that to be the right course of action. They maintain that they could save £6 billion in the current year, representing a cut of £1 for every £100 of government spending. The Liberal Democrats want to go even a stage further and have, according to their manifesto, already identified some £15 billion savings per annum.

The Liberal Democrats have been a great surprise so far in this General Election. Their leader Nick Clegg did extremely well in the first of the three live TV debates and created something of a volcanic eruption in the opinion polls. Whereas both David Cameron and Gordon Brown have had the benefit, if indeed it was a benefit, of American "experts" in political presentation as to how to perform in front of the cameras, Nick Clegg's party simply did not have the money to spend on such niceties. However, it was Nick Clegg who came across as the most natural performer, looking directly at the camera and speaking plainly, whilst David Cameron tried to act statesmanlike but looked somewhat wooden and impersonal. Gordon Brown appeared over-rehearsed, repeatedly banging away about "substance".

In fact, his frequent "I agree with Nick" comments very much helped Nick Clegg, Gordon Brown being very much aware that a Labour/Lib Dem coalition might keep him at No. 10 for another term.

Strangely, the UK's "first past the post – winner takes all" plurality voting system makes it possible for the Labour party to get less popular votes on Election Day than either of the other parties but still manage to hang on to the largest number of seats in the House of Commons.

Last night's debate addressed the leaders' views on international affairs, and the Liberal Democrats' record of being the only major party that was against the Iraq war had put Nick Clegg in pole position. In the event, there was no more "I agree with Nick" from Gordon Brown, as both he and David Cameron attacked various Lib Dem policies, particularly over nuclear disarmament, immigration and Europe. Gordon Brown gave a more prime ministerial performance, and David Cameron looked a lot more relaxed than a week ago. Still, Nick Clegg managed to hold his own, making this General Election very much a three horse race.

It is ironic that David Cameron, who was the one who had been clamouring for a leaders' debate, could well end up losing out on Election Day. In order for the Tories to win an overall majority, they now need a collapse in the Labour vote, and that looks highly unlikely at this point. A hung parliament now is an odds-on bet.

The final debate in a week's time will concentrate on the economy, and the Liberal Democrats will have another trump card to play in the shape of the near-saintly Vince Cable. He has been widely praised for warning the nation about the dangers of Britain living off credit. Furthermore, he also predicted the recession and the housing market problems.

However, the eulogies need to be treated with a degree of scepticism. Over the last eight years or so, he has frequently changed his mind, on some occasions within months, on a variety of subjects, such as joining the euro, light touch regulation of the banks, the level of public expenditure and government interference of the Bank of England. In fact, he has changed his views often enough to prove that he is human after all and, frankly, not unlike other politicians.

Of course, it is easy to change one's views whilst in opposition. The problems come thick and fast once you are the government, when the stark reality dictates what can or cannot be done. In Dr. Cable's defence, it has to be said that he has admitted mistakes. When interviewed by Andrew Neil last year, he said that he had been wrong to support the merger between Lloyds TSB and HBOS.

It is nice when politicians admit that they have got it wrong – we should have more of it! Even Gordon "no more boom or bust" Brown admitted in an ITV interview ten days ago that his move to light touch regulation had been wrong. Maybe a General Election makes politicians realise that a degree of humility and honesty might not go amiss.

Whatever the outcome of the General Election – and it is entirely possible this election will end up changing the political landscape in the UK forever - the British people had better steel themselves for some tough times ahead. Whoever is in power over the next term will become very unpopular in no time at all as the next government will have to hand out some very bitter medicine to its citizens.

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