Quarterly Newsletter / Summer 2010

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

We have had the general election, and now we have a coalition government. It was fascinating to witness the toing and froing between the various parties' delegations in an effort to form a coalition. It quickly became obvious that Labour had lost the will to govern, and it was left to the Conservatives and the Liberal Democrats to find mutual ground. They did so with amazing speed and emerged from their intense discussions and deliberations with confidence and a seemingly homogenous overall strategy. Few voters initially were happy about the outcome, but ten weeks or so later, the mood appears to have changed a little. Bearing in mind the bitter medicine that has to be handed out, it is probably not a bad thing that two parties, rather than just one, have to shoulder the responsibilities that come with the tasks of trying to bring the budget deficit and the overall debt burden under some sort of control.

The coalition Government is warning us that we are entering an era of austerity. That hardly comes as surprising news to anyone who has been aware of the parlous state of Great Britain plc's public finances. As is traditional in British politics when a change of government occurs, outgoing ministers usually leave some notes to help their incoming successors into their new jobs. Liam Byrne, the former Chief Secretary to the Treasury, left his now infamous note consisting of one simple sentence: "Dear Chief Secretary, I am afraid to tell you there's no money left." Under normal circumstances, this would be very funny. Sadly, the words he wrote were true.

We also learned that in the 16 months leading up to the general election, Labour ministers frequently muscled through spending projects despite objections from their civil servants, causing the civil servants to ask their ministers for a "letter of direction" on no fewer than 13 occasions. A letter of direction is requested only when a civil servant deems a spending decision to be either illegal, improper or representing poor value for money. Bearing in mind that there were few such letters asked for previously (1 in 2005, 1 in 2006, none in 2007 and 3 in 2008) it becomes obvious that Labour ignored the ever increasing debt mountain and engaged in what looks like a reckless spending spree. It would be cynical of me to point out that most of these questionable spending projects were in areas that represented marginal Labour seats.

So, austerity it is to be for quite a number of years. This will affect everyone, whether rich or poor. Pay freezes will become commonplace, and once inflation raises its ugly head again, many employees will experience, in real terms, falling wages. The public sector's generous final salary pension schemes and redundancy terms are simply unaffordable and will have to be trimmed. This may seem desperately unfair to those who are affected, but it is a fact that over recent times, increases in public sector pay were much higher than was the case in the private sector. How many people are paid by the public purse? Across England, one in five people work in the public sector, but this figure increases in the case of Scotland (25.1%), Wales (26.1%), and Northern Ireland (29.7%). So, a lot of people will be affected, and there is a real danger that the North-South divide could widen further. Watch out for some high profile strikes, and we would not rule out some sort of civil unrest.

How things have changed in just over a year! At the G20 summit in April last year, Gordon Brown was Keynesianism personified when he led other world leaders in endorsing a huge fiscal expansion. Like John Maynard Keynes, Gordon Brown appeared to believe in active government intervention as the only genuine method of ensuring economic growth and stability. Maybe it was the events in Greece earlier this year that made people re-evaluate the potentially precarious situation we could find ourselves in. Whatever the reason, Labour's 'continue-spending-this-year' manifesto in the end was not well received by the voters, and instead of continuing to live beyond our means, we are now given a financial hair shirt to wear.

Greece, of course, had been an economic basket case for some time, only allowed to continue pursuing a totally unrealistic standard of living (overgenerous public sector pay and holiday packages, a very early retirement age and lavish pension entitlements) by a corrupt former government that simply chose to ignore Greece's economic reality and brazenly lied in order to join what they considered an elite club, namely the eurozone.

It is not just Greece that finds itself in a parlous state. The economies of Portugal, Ireland, Italy and Spain also don't look too healthy right now and have variously been downgraded by the rating agencies.

It may well have been this fear of losing the UK's credit rating triple-A status that has persuaded some of the electorate to abandon Gordon Brown as their ideological leader. Losing the coveted AAA ranking would have made it more difficult for the UK to borrow money, leading to higher gilt yields, higher costs of servicing loans and mortgages, loss of confidence and falling asset prices.

In the recent Emergency Budget, Chancellor Osborne had to walk a tightrope to demonstrate that the coalition was serious about budget deficit and debt reductions whilst avoiding actions that could kill the recovery and lead into a double-dip recession. The public spending cuts obviously will have an effect on GDP growth, and it will be interesting to see whether the private sector manages to step into the breach and offset that negative. Prior to the Budget, we were warned that we should expect very tough measures. In the event, the announced changes were not that severe, admittedly hitting the high earners but leaving the less well paid no worse off. The increase in CGT was not as big as many had feared, and the delay of the 2½% hike in VAT until next January obviously was designed to keep inflation under control in the short term. However, we at Lacomp do not consider inflation to be a threat in the foreseeable future. We are more concerned about possible deflation, particularly if many other countries start embracing the so-called austerity packages.

The crisis in Europe has highlighted the structural problems of its currency, the euro. The strength of the euro always depended on the various member states of the eurozone who, according to the Maastricht Treaty way back in 1991, had to "converge their economies with the average of the two best". This, by the way, was not a hoped-for ideal, the member states were legally obliged to do so! A near impossible thing to achieve, and proof, if proof were needed, that the Maastricht Treaty was politically driven, with very little thought given to the economic side of things.

Of course, many terms and conditions laid down in the Maastricht Treaty have since been changed, abolished or ignored, and we were not wrong when we called it "A Treaty Too Far" in our October 1992 newsletter. Indeed, talking about the euro in that newsletter, we predicted what is now unravelling, likening the euro to "a stagecoach being pulled by two thoroughbred race horses, an Arab stallion, a shire horse, a mule and a donkey".

We now definitely have a two-tier eurozone: Germany, France, Holland, Belgium, Austria and Finland are the good guys, and Portugal, Italy, Ireland, Greece and Spain are aptly given the acronym PIIGS inasmuch as they are the ugly ones. That leaves Cyprus, Luxembourg, Malta, Slovakia and Slovenia who all are doing nicely but are not big enough to bail out the miscreants. That highly questionable honour is bestowed on, above all others, Germany.

It is questionable how long the richer nations within the eurozone will be prepared to prop up the poorer ones. If the Greeks' drastic austerity package does not bring about the desired results, and we are in the camp of those who believe that they will fail in that effort, it is entirely possible that they will be "invited" to leave the euro club, possibly together with some other current members. That would spell the end of the euro as we know it. What the non-PIIGS countries would then do is anyone's guess. Whatever happens, confidence in the currency has been badly damaged and the next year or so will be critical for the euro.

While the euro is losing its lustre and purchasing power against other currencies, the Chinese recently yielded to international pressure by ending the “currency freeze” and allowing the renminbi to move to a managed floating exchange rate. This does not mean that we will see a proper revaluation of the renminbi, but the Chinese currency is likely to steadily rise against the dollar.

How has the UK stock market reacted to the general election result? In the middle of April, i.e. three weeks before the election, the FTSE 100 index looked set to break through the 6,000 barrier, but once it became clear that no party would win a significant overall majority, the market corrected by some 10% in no time.

Since the election, trading volume has been low, and we have witnessed a bit of a roller coaster, with the overall trend downward rather than upward. That is hardly surprising. The new coalition ministers were quick to point out that the financial mess Labour had left them was worse than anticipated. You may call that political retaliation, but it still resonates with people, particularly when the media also talks of doom and gloom to come.

Consumer confidence took a turn for the worse, and that often translates into negative investor sentiment. The new coalition government, in preparing us for a tough budget and a period of austerity, brought about a change in people’s thinking. All of a sudden, we notice savings ratios that are much higher than they have been in years, and economists worry whether those negative messages have been overdone to the detriment of the economy which, put very simply, needs people to spend rather than hoard their money.

It is not just UK investors who suffer an attack of the jitters. The same is true in America where two thirds of the population expect a double-dip recession. The eurozone sovereign debt crisis means that a number of European countries are trying to cut their budget deficits all at once, and even China’s economy is slowing down for the first time in many years. In the case of China, we need not worry. After all, their economic expansion only recently was running in double digit figures, and one of the reasons to abolish the strict currency peg was China’s concerns about an overheating economy. In other emerging markets, the recovery remains robust. In fact, the International Monetary Fund is forecasting global GDP growth of 4.5% this year and 4.7% for next year.

Having said that, one should not be complacent about the economic outlook, and it is for this reason that our portfolios remain fairly defensive. As the old saying goes, “the proof of the pudding is in the eating”. Over the last three months (to the end of June) our CF Lacomp World Fund recorded a loss of 3.1%, whereas our benchmark, the MSCI World index, was down 13.3%. Over one year, our fund increased by 25.9%, and the benchmark managed only 8%.

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