Quarterly Newsletter/Autumn 2009

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

It is now almost official: interest rates are going to stay low for years. The Centre for Economics and Business Research (CEBR), the highly regarded independent consultancy, this week predicted that the Bank rate will stay at 0.5% until 2011 and not rise to 2% until 2014! The CEBR's forecast is assuming substantial fiscal tightening – £20 billion of tax increases and £80 billion of spending cuts over the lifetime of the next parliament – and the likelihood of the Bank of England extending its policy of quantitative easing.

The CEBR also expects the UK economic growth rate between 2009 and 2014 to average 1.4%, which is in stark contrast with the Chancellor's Spring Budget prediction of an annual growth rate of 3.5% from 2011 onward!

Whilst we would hate to be accused of smugness, we actually did predict a prolonged low interest rate environment some six months ago in our Spring Newsletter (at a time when many commentators were worried about inflation and recommended higher interest rates!) and we considered the Chancellor's GDP growth forecast particularly optimistic.

Of course, governments of all hues invariably wear rose-coloured glasses when they predict future economic growth, especially when an election looms, but the Labour Government has been overly hopeful in this regard for a long time. Indeed, when Gordon Brown in his time as Chancellor opened the spending taps back in 1999, he very much assumed that the growth of the economy and its associated flow of taxes into the Treasury's coffers would be sufficient to engage in a massive public expenditure programme. Well, for a while it worked, although the money was not always wisely spent. Even when the music stopped, we were still given unrealistic GDP growth forecasts, and when the credit crunch really bit, the cupboards were bare and the taxpayer became the lender of last resort.

The UK taxpayer is in for a rough ride. Whoever forms the next government will have the very unpleasant task of introducing a much harsher tax regime than we have seen, and that includes the massively increased tax burden we have got used to under New Labour. Anyone thinking that it will only affect the rich is living in a fool's paradise.

Talking of the rich, the government's proposed increase in personal taxation to 50% for earnings in excess of £150,000 may resonate well with a large part of the electorate – after all, according to the Office for National Statistics' Annual Survey of Hours and Earnings, it is only 0.6% of salaried people who are paid that much. However, there is growing resentment among many entrepreneurs who, whether you like it or not, are absolutely essential for a sustained economic recovery. We know of a number of people who are planning to move their operations, or indeed already have moved, to a jurisdiction where taxes are less draconian. Others, rather than focussing on their business, are concentrating their efforts on how to avoid income tax, be that through share-based remuneration (taxable at the CGT rate of 18% rather than facing the 50% income tax rate), Employee Benefit Trusts or a number of other, currently available and legal arrangements. No doubt these schemes will come under close scrutiny of HMRC, and we would not be surprised to see the CGT rate go back up to 40%.

And just when we thought the heavily criticised bonus culture in the City was a thing of the past, we hear that Goldman Sachs is about to pay record bonuses to its executives and traders. The bonuses we read about are staggering in size: Goldman Sachs employs some 30,000 people, and the *average* bonus amounts to £500,000! Of course, the lower paid employees will receive a mere fraction of that sum, but the top executives and traders will get many millions. If you think that Goldman Sachs did not rely on a state bail-out (it actually received $10 billion but repaid it with interest in no time) or had been very clever and prudent in a difficult time, think again. Its success story is very much the result of governments and taxpayers in many countries keeping banks and the financial system afloat. With the credit crunch at its height, Goldman Sachs' own access to liquidity enabled it to make full use of the massive spreads available when buying and selling assets. As one commentator put it, "it was like shooting fish in a barrel". Goldman Sachs recently has come under criticism for operating one of the largest "dark pools". Dark pools, somewhat mysterious not only in name, are electronic, off-exchange trading platforms that the biggest professional investors can use to avoid revealing who they are and what they are trading. They also afford these investors a chance to gain access to information before the general public get a look-in, thus creating a two-tiered market. Trading volume related to these dark pools has gone up significantly in recent times, and the American Security and Exchange Commission is now trying to introduce rules that are designed to curb the dark pools' activities and make them more transparent.

But Goldman Sachs is not alone in being very generous to its employees. JPMorgan and Barclays have already indicated that they, too, are thinking of paying out huge bonuses. Add to that the Royal Bank of Scotland, which would undoubtedly have gone bust had it not been for state intervention that, ultimately, is funded by you and me, the taxpayer. Even RBS has put aside £1.8 billion for its traders. One can only hope Chancellor Alistair Darling and City Minister Lord Myners actually do something rather than just talk about curtailing this sort of remuneration. In America, President Obama has already taken action by telling the bosses of Citigroup, Bank of America and AIG – all recipients of huge state hand-outs – that he would slash their remuneration packages if he considered them excessive. Over here, Bank of England Governor Mervyn King has waded into the debate by calling for the UK's big banks to be broken up into two discrete parts, one dealing with high street retail banking and the other with the riskier investment banking. In essence, this would mean a resurrection of the Glass-Steagall Act 1933 which was established following the Wall Street Crash of 1929 and abolished by Congress (read Alan Greenspan) in 1999. Having become increasingly more critical about the government's handling of the public finances and its plans for reducing the deficit, Mr. King is no friend of Messrs. Brown and Darling, and they both described Mr. King's suggestions as "out-of-date" and "simplistic".

The banks argue that without paying big bonuses, they would be unable to hire people with the right skill set. Hello? Are these not the same supposedly highly skilled people whose short term greed and excessive risk taking led us into the biggest financial crisis in decades?

The public understandably are angry. Having to digest the MPs' (and some Lords'!) expenses scandal, the bankers' apparent lack of sensitivity to the general mood among people is astonishing. It was difficult enough to grasp why bank bosses and their top traders were so hugely rewarded when everyone benefited from a buoyant economy, but with a recession in full swing, rising unemployment and many businesses finding it near impossible to renegotiate their borrowing requirements, this is a very bitter pill to swallow. Maybe Alistair Darling should follow the precedent set by the then Chancellor Geoffrey Howe when he introduced a windfall tax on the banks back in 1981. That might make the banks stop and think!

Talking of MPs, many of them are highly miffed that Sir Thomas Legge has asked them to repay expenses they had considered to be fully within the rules. When Gordon Brown appointed this retired career civil servant to clean up the expenses scandal, little did he think that he himself might be asked to repay more than £12,000! Sir Thomas, simply put, *retrospectively* changed the rules governing expenses. Even Labour's Frank Field, usually a stalwart of common sense, came out fighting, calling it an injustice. He and others who feel similarly have a point. Having been wrong footed ourselves on a number of occasions when Gordon Brown, both as Chancellor and PM, applied taxes and rules retrospectively, we find this rather ironic and quite amusing.

Meanwhile, we are approaching Christmas – only just over two months away – and the postmen are striking yet again. Negotiations between the Royal Mail and the Communication Workers Union have reached an impasse, with both sides blaming each other. Striking postmen are nothing new: in 2008, the postal unions accounted for nearly half the days Britain lost to industrial action. The situation now is dire: mountains of undelivered mail, particularly in London and the South East, will grow to even bigger dimensions, and many businesses currently struggling with the recession are desperate for an efficient postal service. Make no mistake about it, this latest round of strikes will hurt the Post Office, as many of these businesses are looking towards independent delivery firms and will not return to the Royal Mail when the postmen go back to work. But spare a thought for the postmen. Whilst they assiduously have been paying into their pension scheme, the government saw fit to allow itself a 13-year contribution holiday. The Royal Mail is now weighed down with a £3.4 billion pension deficit, despite the fact that, in the 1990s, it managed a surplus of £2.5 billion which, unfortunately, was paid into the Treasury's coffers rather than reinvested thus rejuvenating its own systems.

The whole argument between management and the unions came about following the plan to sell off part of the Royal Mail. Initially triggered by a 1997 EU directive to "open up the postal sector to competition", it badly misfired on the government. Business Secretary Peter Mandelson, lifted out of Brussels and parachuted into the Lords, ran into the biggest backbench revolt since New Labour came to power and had to abandon the privatisation plans. So, if you want to send some Christmas presents to your loved ones, we suggest you post them sooner rather than later.

Being more serious and looking at the financial markets, the year to date has been quite extraordinary. From the beginning of January to 6th March, when markets bottomed, stock market valuations were steadily falling. The MSCI World index, the Dow Jones and the S&P 500 all were marked down by just over 24%, the Eurostoxx 50 by 25.9% and the FTSE 100 by 20.4%. The Far East did marginally better, with the Hang Seng falling by 17.1% and the Nikkei Dow by 19%. By contrast, our own CF Lacomp World Fund fell by "only" 8.6%, no doubt a reflection of the more defensive stance we had adopted some time ago.

From 6th March onwards, we have seen a rally that not only offset the losses of the first two months but pushed ahead very strongly. A word of warning, though: this rally has been achieved against relatively low trading volume, which usually makes one rather suspicious about the true worth of valuations. More worryingly, some industry experts reckon that a significant part of the volume in today's markets is down to high-frequency trading. Often referred to as "flash trades", this is a game for the big boys, i.e. the dark pools who rely on powerful computers to carry out big volume trades in microseconds. Critics again point to a two-tiered system that does not allow other investors to participate.

In any case, the recent rally only brings us back to more reasonable valuation levels. For example, even though the Dow Jones has added over 50% in value since 6th March, it is still 12% lower than its valuation the day before Lehman Brothers went under just over a year ago.

Other statistics make interesting reading: the oil price doubled between February and June of this year, gold started the year at $860 per ounce and has added some $200 since, and US unemployment since January has increased from 7.6% to nearly 10%. The Baltic Dry Index (measuring the costs of shipping commodities and raw materials) has recovered from its low of 773 in January to 2,800 at present, but it is still massively down on its mid-2008 level of over 11,000! Finally, we are very aware of the steadily sliding value of sterling, which is tantamount to a devaluation by stealth.

The real question is this: is the recession – both global and British – over and is the recovery sustainable or are we looking at a double-dip recession, with repercussions in the markets? It will be some time before we will know the answer and Lacomp, whilst remaining invested, has maintained a cautious approach in portfolios during the recent market surge.

22nd October 2009

Lacomp plc
77 High Street, Bagshot, Surrey, GU19 5AH, England.
Tel: (Int 0044++) (0)1276 475123 Fax: (0)1276 475273 e-mail: info@lacomp.co.uk website: www.lacomp.co.uk