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

Markets, the Recession and UK Politics

When Bill Clinton was the Democrats' presidential candidate against the incumbent George Bush senior in the 1992 US elections, his campaign manager coined the phrase "it's the economy, stupid".

Looking at financial markets, the same slogan could be applied now. It all hinges on what view you take about the outlook and sustainability of the UK economic recovery and, indeed, that of the world. Throughout spring, there had been some positive signs that the worst may be over. Improving consumer sentiment, rising retail sales and increased manufacturing activity, to name but a few, augured well, but renewed concerns about excessive government indebtedness knocked the stuffing out of any hopes that had been built up. Standard & Poor's saw fit to move the UK's medium-term outlook rating from "stable" to "negative", threatening the country's AAA sovereign credit rating. When the retrospective economic data covering the first quarter of 2009 became known – including the worrying fact that GDP had contracted by 2.4%! – the figures were negative across the board, prompting Bank of England Governor Mervyn King to voice his grave concerns about the UK's economic outlook.

To date, 2009 has seen varying stock market performances. Whilst all Asian markets have recorded positive performance figures, Europe and the UK have been largely negative. American indices varied quite a bit: the Dow and the S&P 500 were down 7% and 3% respectively, whilst the NASDAQ increased by some 11%. Trading volumes have been relatively low, and that of course does not help improving investor sentiment which at best can be described as fragile and rather gloomy.

On the other hand, only this week US Treasury Secretary Tim Geithner, on a flying visit to European and Middle Eastern countries, stated that there was a very strong chance of economic recovery in the US and elsewhere during the current year.

Who is to be believed? Well, anybody who claims to know where exactly we are heading is simply not worth listening to. There currently are so many unknowns in play that it is impossible to make reasonably accurate predictions. Monetary policy, quantitative easing, and government indebtedness are among the very big question marks.

Let's consider monetary policy first: The American Treasury and the Bank of England Monetary Policy Committee have been quite aggressive in slashing interest rates. In the US, it took only 14 months from September 2007 to cut their target rate from 5.25% to 0.25%. The UK followed suit by starting their interest rate cull a little later, in November 2007, and it took the MPC a little longer to reduce the Bank rate from 5.75% to 0.5%. In so doing, both American and British central banks largely ignored the inflationary sting in the tail that often follows substantial easing of monetary policy. A cynic might further point out that making cheap credit available to stave off a recession seems a bit daft when it was cheap credit that brought about this worldwide financial crisis in the first place.

By contrast, the European Central Bank dragged its feet somewhat, citing its concerns about inflation as the reason to be more hesitant in reducing rates. Indeed, the ECB even raised its rate in June 2008, but it has since reduced it to 1%.

These unprecedented levels of low interest rates were arrived at in a desperate attempt to reduce interbank lending rates and also lower the costs of credit in order to stimulate the economy. In other words, it was done to counteract the credit crunch which, in simple terms, meant that interbank lending *and* lending by banks to businesses, both absolute necessities for an economy to work, had virtually dried up. Banks did not trust each other with their money, and they certainly did not trust businesses because of the poor outlook for the economy. The reason banks did not trust each other? They simply did not know how financially sound the other banks were, and how much of their assets were "toxic". When Lehman Brothers were not bailed out and allowed to go under, you could almost smell the fear that gripped the banking sector. Share prices plummeted, and within days the powers that be brokered the ill-fated deal between Lloyds and HBOS.

And that brings us to the next "unknown", namely quantitative easing (QE). Much has been written about central banks printing money to increase the money supply. It is a government's ultimate recourse to get lending going when near zero interest rates have not done the trick. Nevertheless, there is little historical evidence that this experiment actually works.

As we know, QE had been tried in Japan in 2001, and the jury is still out as to whether it brought about the desired *long-term* results. It certainly provided the commercial banks with plenty of liquidity, and the yen did not seriously depreciate in value. One glaring difference between Japan in 2001 and the current situation is the fact that deflation had already taken hold in the 1990s, which reduced the efficacy of QE somewhat. The prediction in 2001 that Japan would suffer high inflation following QE certainly has been proven wrong. In fact, Japan even now is more worried about being caught in another deflationary spiral, and some inflation would be quite welcome.

The UK was first to announce a QE experiment, followed by Washington. The figures are huge: £125 billion in the UK (recently reduced from the originally planned £150 billion but to be reviewed again in August), and a staggering amount of over $1 trillion in the US!

At the risk of oversimplifying what is, after all, a hugely complex subject, the British Government is buying corporate bonds, gilts and other fixed interest securities from the banks, thus affording the banks increased liquidity whilst, at the same time, creating demand for and thus depressing the yield of these papers. The idea is that the banks will end up with more cash and that they will have to return to lending to businesses rather than just sitting on secure commercial and sovereign paper which has been the case latterly. So far, the banks are proving very reticent and restrictive in their lending policies, and it will take some time to see whether this strategy yields the hoped for results.

Another disappointment, whilst on the subject of lending, is the much vaunted Enterprise Finance Guarantee (EFG) which Lord Mandelson, in his guise as Business Secretary, unveiled in January, and which replaced the old Small Firms Loan Guarantee (SFLG) scheme. Although the government claims to offer more support to small businesses to help them weather the recession, official figures prove the government wrong. In March 2008, the government set a budget of £360 million, which it increased to £1.3 billion in January of this year. However, in the 12 months to end of March 2009, businesses received guaranteed loans of only £178 million under the SLG and its successor EFG, whereas the previous year to March 2008 saw a significantly higher figure of £205 million! So, whilst the government and the banks have been telling us that lending <u>was</u> taking place, the reality has been different.

It would appear that even the government has at long last woken up to the fact that there is a problem, and we have just learned that Chancellor Darling is summoning the bank chiefs to a meeting in Downing Street. He will quiz them as to why the banks, many of whom are partially owned by the taxpayer, have not been lending to businesses and individuals.

Mortgage rates, for instance, have risen to record levels when compared to the low 0.5% Bank rate. We predicted this as a likely scenario in our last newsletter, as it was pretty obvious that the banks would prefer to shore up their balance sheets rather than engage in lending, particularly as the FSA had voiced its intention to raise the banks' capital adequacy and liquidity requirements.

The third "unknown" is the government's indebtedness. Well, we have a pretty good idea about its size, but the unanswered question is how much bigger it is going to get and how we can get our public finances into some semblance of order. That will depend entirely on which political party will rule after the next general election, what their agenda will be, and whether they will stick to it.

According to the National Office of Statistics, the total public sector net debt of the UK at the end of May amounted to a staggering £775 billion (or 54.7% of GDP). More worrying is the 2009/10 Budget forecast for net borrowing of £175 billion! This equates to approximately 12% of GDP. Do you remember the 1992 Maastricht Treaty and its euro convergence criteria which stipulated, inter alia, that the Budget deficit must not exceed 3% of GDP? 12%, indeed!

The Prime Minister keeps telling us that he will not have to cut public spending and talks of net increases in areas such as health and education. If that were true, and please bear in mind he has told the electorate a few whoppers over the last 12 years, we would be faced with the most unbelievable tax increases. Much has been made of the top rate income tax band of 50% for those earning over £150,000 per annum. Quite frankly, that on its own is not even going to make a noticeable dent in the nation's debt.

In order to actually reduce this enormous debt mountain, we had better get used to the idea of something like a 5% hike in the basic rate of income tax, an increase in the VAT rate to, say, 20%, *as well as* real cuts in public spending. If, and this is a big if, these measures were to be coupled with increased tax revenues from an improving economy, a significant reduction in the national debt could result.

Of course, no politician will tell you anything like this. Politicians are notoriously unwilling to talk about tax increases or cuts in public spending, believing that the voters will turn against them at the ballot box. Instead, we are treated to almost ludicrous exchanges during Prime Minister's Question Time, when the PM and the Leader of the Opposition talk about 10% increases, zero percent increases (whatever that means) and "real" or "perceived" cuts. It would be so refreshing to hear our political leaders talking in a straight and honest manner. Following the expenses scandal, our politicians need to rebuild public respect and trust in what they are about, so that we once more can believe in the ideals of a true democracy rather than feel our system of governance is degenerating into a form of kleptocracy.

There is little doubt about it: our government, in all its forms, has become very bloated and wasteful. The 646 Members of Parliament in the House of Commons and the 740 peers in the House of Lords – with both Houses likely to undergo a reduction in numbers before long – are only the tip of the iceberg. If you add the British Euro MPs, the members of the Scottish Parliament, the representatives of the Welsh, Northern Irish and London Assemblies as well as town hall councillors and the political advisors, you will end with over 29,000 paid politicians, costing the country an estimated £500 million a year.

Whilst last year saw a wave of redundancies in the private sector, the public sector managed to create another 30,000 jobs, according to the office of National Statistics. Some of these new jobs are of dubious value to the community and are often referred to as "non-jobs", including advertised posts for such important openings as Head of Participation and Inclusion, Equality and Diversity Manager, European Programme Policy Officer and, to top it all, Community Space Challenger Co-ordinator! These jobs were advertised at salaries ranging from £28,494 to £42,197. It would be unkind to suggest that we might be looking at a different form of gerrymandering.

Returning to Gordon Brown's central government, you may ask yourself why we need 120 Ministers, of which 23 make up the Cabinet. By comparison, Switzerland manages with seven.

To make matters worse, there are also the quangos (the acronym "quango" stands for "quasi-autonomous non-governmental organisation"). They made the news just a few days ago, mainly because their top executives, who by the way are appointed, not elected, have awarded themselves pay rises of up to 20% over the last year. Many of the quango bosses earn well over £200,000 per annum. Nice work, if you can get it, unless you happen to be employed by Goldman Sachs!

Bizarrely, nobody seems to know exactly how many quangos there are, and estimates range from 800 to over 1,100, and the cost to the nation is reckoned to be in the region of £64 billion! When you study the list of *known* quangos, there seems to be a lot of duplication in the work they perform. For example, in England alone, there are *ten* quangos that deal with "Patient Welfare". On the other hand, many quangos are very necessary and well known (for example the Charity Commission, Civil Aviation Authority, DVLA and our own regulator, the FSA, to name but a few), but some of them look rather more obscure. Northamptonshire is not exactly a huge county in terms of either population or size. However, there is a quango called the *West* Northamptonshire Development Corporation which employs 34 people and costs the taxpayer £15 million a year, and the British Potato Council employs 49 people at an annual cost of £6.5 million. We thought you might like to know.

Housekeeping

You very likely will have read press reports about the FSA introducing new rules banning commissions for financial advisers. The new rules come into effect in 2012 and will aim to stop any "product- or commission-bias" that in the past has led to a number of mis-selling scandals. They furthermore aim to differentiate between "independent advice" and "restricted advice". We at Lacomp welcome this development, as we have always taken a very dim view of some financial products, in particular insurance linked investment bonds, that paid up to 9% (!) to introducers. After 2012, clients will have the choice of paying for advice through either an upfront fee or having the cost deducted from their investments. New Client Agreements will have to be drawn up nearer the time, but the new regime will not fundamentally change the way Lacomp receives its remuneration for the services offered, and we will continue to pass on to you any discounts we negotiate on your behalf.

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