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

Here we are, at the beginning of a new year and, as conventional wisdom would have it, at the beginning of a new decade, signifying the end of the "noughties". "Noughties" is a rather peculiar term, to put it mildly. It does seems a bit odd, in truth, that we appear not to be too sure when a decade actually starts or finishes.

Whether we are at the end of the decade or merely 9/10 through it does not really matter. What does matter, however, is where we find ourselves in terms of economic recession or recovery. What is beyond doubt is the fact that we have gone through a very deep recession, and we think it is only fair to declare that the writer of this Newsletter did not believe that it would be quite as severe as it turned out to be. In our defence, though, we have to say that we could not have envisaged that our banks, having been bailed out by governments and/or taxpayers, could still be so recalcitrant when it came to performing one of the basic obligations of our banking system, namely to lend money to people or businesses that merited being lent money to. We have witnessed a number of cases where well established and properly run businesses have been starved of much needed finance, resulting in their either not being able to develop in line with their realistic and achievable business plans or, more importantly and ultimately fatally, have gone bankrupt. That was disgraceful, and a poor indictment of our government who allowed it to happen.

The reason why the failing banks in the UK had to be rescued by the government – or, more to the point, the taxpayer! – is very simple. A country's economy, in order to function properly, absolutely needs financial stability, and the banks play a key role in providing it.

However, our banks, having been perfectly happy to apply very lax lending criteria for years before the credit crunch, have since changed tack and become ultra cautious, preferring to shore up their balance sheets and only lending when they perceive a loan to be virtually risk free. True, some would-be borrowers went cap in hand to the banks in order to ease their cash flow problems, but plenty of good businesses were denied what should have been available under our banking system.

When the government decided, for the first time in UK history, to try quantitative easing (QE) as a means of solving the credit crunch, we were told that the main rationale for this move was to get banks lending again. Just to recap briefly, when the dramatic cuts in interest rates between September 2008 and March 2009 to 0.5% (the lowest since the Bank of England was established in 1694) had not been sufficient to stimulate consumer spending and the economy as a whole, the government decided to use QE as the last weapon in its arsenal to boost money supply. QE is very much akin to printing money that previously had not existed, and its effect is to increase the Bank of England's balance sheet and the country's monetary base. The "new" money is used to buy assets from the distressed banks – mostly corporate bonds and gilts that the Bank of England hopes to sell back into the market once the economy has recovered – and this obviously would improve the troubled banks' liquidity and give them the cash to engage in a bit of lending which, in turn, would stimulate the economy. Well, that was meant to happen in theory.

So far, the Bank of England has made £175 billion available through QE, and another £25 billion is earmarked to follow by the end of this month. However, there is precious little evidence that the "real economy", i.e. businesses and industries, have benefited from QE, the exception being, you guessed it, the banks! We believe the UK government should have taken a much firmer line and forced the banks to make reasonable credit lines available to both businesses and individuals.

In March last year, the government originally planned QE to be limited to £150 billion, curtailing it in the summer to £125 billion. However, it now looks like £200 billion will be injected into the economy. Getting the extent of QE right is quite a tricky balancing act. Too little will not have the desired effect and may not curb deflation, and too much could lead to inflation. If you were to print far too much money, it could lead to hyperinflation. Two examples of hyperinflation spring to mind: Germany's then Weimar Republic in the 1920s and Zimbabwe very recently.

Indeed, some economists point out that the latest increase in inflation figures may well signal the end of QE after this month. According to the Office of National Statistics, the Consumer Price Index (CPI) recorded its largest jump in one month since records started in 1997, up from 2.1% in November to 2.4% in December. The Retail Price Index (RPI) is also estimated to have gone up sharply. It is worth remembering that there are substantial differences between the two indices. The CPI excludes a number of items relating to housing costs, including council tax and mortgage interest, estate agents' fees and conveyancing costs.

Having thus exceeded the Monetary Policy Committee's target of 2%, Bank of England Governor Mervyn King will have to write to Alastair Darling to explain the "transgression". So, although inflation is once again being talked about, we at Lacomp believe that we will remain in a prolonged period of low interest rates and low inflation, irrespective of what the short term inflation figures are suggesting.

The adjective "obscene" usually has sexual connotations as it is often used when accepted public morality of the day is offended. Think of the famous obscenity trials concerning various publications, namely "Fanny Hill" in the 18th century, "Lady Chatterley's Lover" in 1960 and "Oz Magazine" in 1971. This use of the word "obscene" in these instances may have been a little misguided, as the word comes from the Latin *obscenus*, which means "foul, repulsive or detestable".

Why are we talking about obscenity? Well, Goldman Sachs, Citigroup, Bank of America Merrill Lynch and Morgan Stanley, four of the biggest American banks, are telling us that they plan to pay out huge bonuses to their staff. The total sum of salaries, benefits and bonuses is in the region of $100 billion! Of these four banks, only Goldman Sachs is expected to make a profit, and we touched on their privileged position during the credit crunch in our last Newsletter. True, most banks' investment banking divisions have done well, but that was only possible because of the bailout by governments around the world. It is rather galling that the very people whose reckless risk taking and short term profit thinking caused a lot of good businesses to go under during the ensuing credit crunch should now be rewarded with bonuses that, in most cases, are similar to those paid out in 2007, the last boom year for investment bankers. Barclays is expected to pay out over £3 billion in bonuses, and even Britain's most disastrous performer in the banking world, the Royal Bank of Scotland - some 85% of which is now owned by the British taxpayer - plans to pay out bonuses amounting to £1.5 billion, with some RBS bankers expected to receive around £15 million. Now that is obscene!

In America, President Obama took action last week by unveiling what he called a "financial crisis responsibility fee" by forcing America's biggest banks to pay a $90 billion "penalty". The President said: "If these companies are in good enough shape to afford massive bonuses, they are surely in good enough shape to pay back every penny to taxpayers." This will resonate well with the man in the street, but it will take years to make good the shortfall faced by the US Treasury.

Yesterday, Barack Obama went a stage further in his war on Wall Street excess. Basically, he wants to separate the plain vanilla commercial banking from the riskier investment banking, and he wants to "break up" banks so that none will be so big that they cannot be allowed to fail. This proposal is not that dissimilar to the imposition of the Glass-Steagall Act back in 1933.

President Obama has had quite a first year in office, and his personal approval rating has taken a hammering, particularly over his health care reform plans. If and when his bill succeeds, it will be a heavily pared-down version of what he had intended, particularly after the Democrats lost the late Edward Kennedy's Senate seat in Massachusetts earlier this week.

Looking back over the last year, equity markets, having gone through a negative first quarter, recovered very strongly during the next three quarters and posted some truly impressive results. As we have often stated, the markets always look beyond the near future and try to second-guess what comes afterwards. The net result is that shares now are by no means cheap, and we will soon see whether investor sentiment has been too optimistic too soon.

What, for instance, will happen when various governments have no choice other than to rein in their spending and start repaying the huge borrowings they have incurred in trying to keep their economies afloat?

The UK is a good case in point. As we know from the political debate (early electioneering?) currently going on, Gordon Brown is of the view that government spending has to continue to get Britain out of the recession, irrespective of the additional debt he is burdening the country with. He is not alone with this view. Dominic Strauss-Kahn, the head of the International Monetary Fund (IMF), recently urged countries not to end their respective fiscal stimulus packages. Of course, the IMF boss also is a politician with left wing tendencies, and he does not have to consider the UK's specific problems when he makes his views known. Britain, as we all are only too aware, is already saddled with an absolutely staggering debt, and exacerbating the situation in the way Gordon Brown suggests is a risky strategy. Apart from the £800 billion or so debt burden as a result of bailing out the banks, Britain also faces a huge public sector deficit, around £160 to £180 billion, depending on whom you believe.

The UK is in a very tricky situation, not helped by rumblings that credit rating agencies are considering removing Britain's coveted AAA status. The agencies, Standard & Poor's, Moody's and Fitch Ratings who between them effectively control the whole ratings game, hardly covered themselves in glory during last year's financial mayhem. Nevertheless, these arbiters of credit-worthiness are extremely powerful and influential. If the UK were to be downgraded, it would become increasingly difficult for the country to borrow money other than at exorbitant interest rates. This recently has happened to Ireland, Spain and Greece, and the euro is suffering as a result. It highlights the problems of having a common currency with one central bank but 16 member nations dealing with the recession in an uncoordinated way. The situation in Greece is particularly serious, where a bloated public sector has dragged down the

economy. If this sounds a bit too familiar for comfort, look away.

Alastair Darling's "do-nothing" pre-Budget Report was a complete joke, totally ignoring what has to be done to get the public finances into any semblance of order. He already had to accept that his previous forecasts for GDP growth were wildly unrealistic, and in this he follows the precedents set by his predecessor, Mr. Brown. Recently, at least, Mr. Darling is beginning to acknowledge and voice his concerns about the debt mountain.

We gather there have been a few terse conversations between the current occupants of No.10 and No. 11 Downing Street (a question of déjà vu, perhaps?) revolving around the issue of when to start cutting public spending and, more to the point, whether to tell the electorate. As recently as two weeks ago, Gordon Brown still was unable to change his rhetoric from his vision of a Britain full of aspiration and opportunity, and he stated that he wished to continue with his spending spree which he is sure will get us out of the recession more quickly. He continues blaming others for the problems we are now facing, which is a bit rich bearing in mind he has been at the very heart of government and the holder of the purse strings for the last 13 years. Mind you, the very recent "palace revolution" at the heart of the Labour party and the ensuing pressure brought to bear on him by some of his closest cabinet "friends" may have resulted in a slight change of heart.

This latest episode, poorly devised and miserably executed by ex-cabinet colleagues Geoff Hoon and Patricia Hewitt, is the third coup attempt by parts of the Labour Party to get rid of their leader since his coronation as Prime Minister in June 2007. Gordon Brown has been called the great ditherer, particularly after his "it's on, it's off" general election plans in the autumn of 2007, but the people wishing to replace him at the helm appear to be no more decisive. The old bruiser Ken Clarke hit the nail on its head when he declared, on Andrew Marr's Sunday morning BBC program: "They are very bad at plotting in the Labour Party. They hide behind the knife and stab with the cloak".

So, we are in for a very long election campaign, and in trying to demonstrate unity within the Labour party following the latest putsch attempt, it will apparently be Lord Mandelson, Douglas Alexander and Harriet Harman who will run their campaign. Interestingly and rather strangely, Gordon Brown's personal approval rating has increased markedly in the last two weeks. There have been some attempts by him and Ed Balls to play the "class war" card, and an air-brushed image of David Cameron probably was not the best answer. They might have done better by focussing on some "non-members" of the Bullingdon Club in the Shadow Cabinet, such as William Hague, Michael Gove and Ken Clarke, all of them experienced, bright and able politicians but without a particularly privileged background.

The trouble with British politics at present is that the three main parties all want to occupy the centrist ground and this, coupled with the voters' disgust over the MPs expenses scandal, may well allow extremist fringe parties to play a bigger role at the general election.

The Tories have not helped their cause by only half-heartedly talking about cuts in public expenditure. Surely, this is not the time for being coy. The electorate is not that stupid, and voters know that Britain is in for a tough time ahead.

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