Quarterly Newsletter
Winter 2010/2011

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

We usually start our January newsletter with a quick review of what the financial markets returned in the previous year. As we have said in our last newsletter, 2010 provided us with something of a roller coaster. Overall, the year ended with mixed results: in stock market indices terms, China (Shanghai Composite) was the worst performer (down 14.3%) and America's S&P 500 the best (up 12.8%). Between those two extremes, you found the other major indices: Dow Jones up 11%, FTSE 100 up 9%, MSCI World up 9.6%, MSCI BRIC (Brazil, Russia, India and China) up 0.7%, Japan's Nikkei 225 down 3% and Europe's Eurostoxx 50 down 5.8%. The oil price rose by 13.4% and gold was the star performer with a gain of 28.4%. After an excellent performance in 2009, Sterling Corporate Bonds registered a very modest 2.7%, matched by the FTSE All UK Gilt Index at 2.8%.

The CF Lacomp World Fund, we are pleased to say, was up 19.5% for the year.

Over the course of the year, we witnessed some major upheavals, starting with the Greek debt crisis and its associated riots, resulting in a €120 billion three-year bailout plan. Ireland, Portugal, Spain and Italy also were in potential trouble, leaving a big question mark hanging over the Euro as a currency and the Eurozone as a trading bloc. Additionally, there were tensions over the value of the Chinese Renminbi among concerns about China's economy overheating, and there was political violence in Thailand. We then had the Gulf of Mexico oil spill and the Icelandic volcano eruption, the latter grounding a lot of international flights. The airline industry had already been suffering long before then, and May saw the creation of the world's largest carrier with the merger of United and Delta. America's weak housing data and Goldman Sachs facing fraud charges over the sub-prime crisis didn't help investor sentiment either. The European sovereign debt crisis was blamed for May's "Flash Crash" at Wall Street, which saw the Dow Jones losing over 600 points in 5 minutes, ending the day 1,000 points lower!

If you consider all these events, it is hardly surprising that the markets' movements reminded one of a roller coaster. On top of that, there were serious concerns about the global economic situation, with the UK's economy being no exception.

If things don't improve, the UK is only three months away from a technical double-dip recession. In other words, after the previous recession, we have seen a short-lived recovery, but the fourth quarter of 2010 has seen a rather unexpected fall in GDP of 0.5%, and another negative GDP performance in the first quarter of 2011, i.e. two quarters in a row, will see us back in recession. Of course, we may by then be experiencing a better economic climate which, bizarrely, could see us in a recovery phase at the very point when we are being declared officially in recession.

Confusing? Well yes, it does rather amount to economists' mumbo-jumbo, but it will be embraced gleefully by commentators, journalists and opposition politicians alike. You can just picture the newly appointed Shadow Chancellor Ed Balls laying into the coalition government's economic policies whilst fervently hoping that we have forgotten the fact that he was the chief architect behind Gordon Brown's 'borrow and spend' approach. Indeed, one is reminded of Michael Heseltine's quip "It wasn't Brown's, it was Balls'!"

To keep things in perspective, in our last newsletter we predicted a weak recovery - albeit with ups and downs - thus making it entirely possible that we will see quarters where GDP growth turns into GDP slippage.

Still, the final quarter's GDP decline of 0.5% did surprise us, and the cold snap in December which brought nearly the whole country to a standstill had a lot to do with it. In fact, the Office for National Statistics reckons that GDP growth without the climatic interruption would have been "flattish" - now there is another interesting term to describe the British economy. It wasn't just the weather, though, that led to the negative GDP performance. Before the first heavy snowfalls hit Britain, the mood among commerce and industry had already changed from a degree of optimism to a more pessimistic outlook. Apart from all the upheavals earlier in the year that we touched on above, there were renewed concerns about a currency war (mainly between the US and China), the Democrats lost the House to the Republicans, tensions between North and South Korea rose to a dangerous level, the Federal Reserve announced Quantitative Easing (Mark II) and the Irish banking crisis reached a crescendo which eventually resulted in a Greek-style bailout.

Ireland and Greece now have to pay heavy interest to raise any money, and their ten year bond yields currently stand at around 9% and 11% respectively. Compare those rates to the ones applicable in the UK (ca. 3.6%) and Germany (ca. 3.1%), and you can see why the coalition government is keen to keep a tight rein on the public purse. The Bank of England's Monetary Policy Committee (MPC) has kept the base rate very low at 0.5% for over 21 months, but there are those, including a member or two of the MPC, who call for a tightening of the policy. Their hawkish arguments mainly relate to the recent increases in inflation, but the MPC doves will have you believe that the recent hike in inflation is merely temporary.

A year ago, the Bank of England predicted that inflation would be running at 1.5% by the end of 2010 which turned out to be a poor prediction with the Consumer Price Index (CPI) for December 2010 at 3.7%. Bearing in mind that the CPI stood at 3.5% a year ago, the Bank of England's forecast did look rather optimistic. Strengthening commodity prices have not helped, resulting in higher food and fuel prices. We all know that it costs a lot more to fill the petrol tanks in our cars, partly also due to hikes in duty on petrol. It is reckoned that a one penny increase in petrol duty puts another £500 million in the Treasury's coffers, but it also adds an average of £500 per annum for each lorry on the road, and since haulage costs invariably get passed on to the consumer, this also feeds into the inflation figures. Gas, heating oil and electricity bills also have ballooned in recent times.

An increase in the base rate would undoubtedly be beneficial if you only wanted to curb the CPI, but it would make any borrowing more expensive. This would be very bad news for many people and businesses paying off their mortgages or other debts, as lenders have a nasty habit of speedily passing on any rate increases to the borrower. Consumer sentiment, which has held up remarkably well despite the predicted period of austerity, could quickly turn negative, with potentially dire consequences for the economy. The MPC members have a difficult task to determine which course of action to follow. We at Lacomp believe that the weak recovery will make it unlikely for interest rates to rise in any significant way for quite some time. The newly applied higher VAT rate will certainly contribute to a hike in CPI, and it remains to be seen whether that is another “merely temporary” phenomenon.

The coalition government is facing a difficult time this year. The trade unions already have called for serious strike action, and social unrest when the cuts really start biting cannot be ruled out. The coalition’s approach to reshaping the political, sociological and economic landscape appears to be quite radical. Social welfare, education, the NHS and the way we elect our parliamentarians all are set to undergo significant reform. Needless to say, the Conservatives have had a long time in opposition to properly plan their strategies for the time they would be back in power, but the need to placate their coalition partners undoubtedly means granting them concessions. The danger here is that some of the amendments to policies will have to be made on the hoof.

The resignations of Shadow Chancellor Alan Johnson and David Cameron’s communication director Andy Coulson mean that both parties have lost a key player from their ranks. Both Johnson and Coulson were part of Labour’s and the Tories’ inner circles, and as neither man had come from a privileged background - Johnson used to be a postman and Coulson started work at 18 as a junior reporter on a regional paper - it was felt that they would keep the rather elitist leadership teams of both parties (mostly Oxbridge or similarly educated and rather posh) “grounded”. The appointment of Ed Balls as Shadow Chancellor gave the press a field day, telling us that “two Eds are better than one” and, with reference to the recent Labour leadership contest, speculating how long it would be before Milliband and Balls were going “Ed to Ed”...

The announcement of negative GDP growth probably made it difficult for Ed Balls to suppress a smile, but another revelation this week would have turned any smile into a grimace. Documents released under the Freedom of Information Act reveal the true costs of the Private Finance Initiative (PFI) schemes’ “investments”. Just to recap, the PFI was introduced by John Major’s government, but it grew to massive dimensions under Chancellor Brown and, yes, his sidekick Ed Balls who served as an economic advisor to Gordon Brown since 1994. We have written about PFI in previous newsletters, pointing to the fact that it provided the government with an elegant solution to keep major projects that normally would be financed by the public purse “off the balance sheet”.

Take, as an example, a hospital or a school that needed building. Instead of making that expense part of public expenditure, it was private finance (call it a developer) that provided the money for the project. The developer, in this case, would then own the building, usually for around 30 years, and charge the government rent and maintenance costs. In effect, PFI was meant to save the taxpayer a huge outlay at the outset by enabling the project to be financed over the longer term. Unfortunately, Whitehall’s negotiators or their outside consultants would appear not to have been the best at negotiating, resulting in the taxpayer paying ludicrous amounts of money for very poor value.

The figures released this week show the following: recently built hospitals and schools (and a number of other projects) under PFI represent a capital value of £56 billion, but they will cost the taxpayer a total of £229 billion! To make matters worse, some of the projects run for not just 30 years. Several of them have an “investment term” of 60 years, and some of the contractual obligations beggar belief. We now learn about exorbitant sums being charged by contractors for the most simple of tasks. Furthermore, in Belfast, for example, a school built and financed under the PFI scheme closed after 6 years, but the PFI contractor will be paid

£360,000 per annum for another 17 years! So, whilst the current taxpayers are in for a difficult ride in the short term in any case, some of these additional liabilities that have been unveiled and fully exposed only this week, will have to be met by the next two generations.

The economic climate remains tough with headwinds present in all developed economies, and the measures outlined in President Obama's "State of the Union" speech fell far short of the austerity packages announced or already followed in Europe. Given the level of US public expenditure - with approximately 40 cents of every dollar being spent having to be borrowed! – as well as a consumer sector hampered by stubbornly high unemployment and a dysfunctional, oversupplied housing market, one's attention inevitably is drawn towards Asia as a potential saviour of the global economy. Asia, whilst not without its own economic headwind, faces problems that have more to do with inflationary pressures rather than sluggish recovery. At Lacomp, we expect the Emerging Markets' indices to continue their upward trend.

Where does all this leave the UK stock market, though? Corporate balance sheets look remarkably strong, probably due to some aggressive cost cutting during the early months of the recent recession. It is likely that corporate profits will hold up despite indifferent GDP growth, particularly for those companies selling into developing markets whilst sterling remains weak. The uncomfortable truth might lie in a jobless recovery, meaning that the economy could expand whilst unemployment does not fall or, even worse, increases. Despite the fact that such a scenario would spell bad news for the younger generation looking for jobs, it would not deter share prices from moving upwards over the coming year although there may be plenty of adverse economic news to disrupt a smooth return to more "normal" times.

Bagshot 27th January 2011

Lacomp plc
77 High Street, Bagshot, Surrey, GU19 5AH, England.
Tel: (Intl. +44) (0)1276 475123 Fax: (0)1276 475273 e-mail: info@lacomp.co.uk website: www.lacomp.co.uk & www.lacompeisfunds.co.uk