



AAG

Market Bulletin

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This weekly Briefing Note aims to pick out some of the key financial and economic issues touched on in the press over recent days, and from time to time includes the views of some of our independent fund managers.

Painting by Numbers

The highlight of the week was of course the Budget, the contents of which had mostly been leaked beforehand but which nevertheless gave Alistair Darling the opportunity to spread a little optimism amidst the financial gloom. The numbers were rather worrying and for some – notably those earning more than £150,000 per year – positively horrible. The Chancellor understandably started by getting the bad news out of the way first – divulging how much the government would have to borrow to extricate the country from its current parlous state. With the economy predicted to contract by 3.5%, public borrowing is set to rise to £175bn this year (equivalent to 12.4% of GDP) and, although the Chancellor predicts a return to growth next year borrowing is still planned to be £173bn. As **The Financial Times** pointed out, the net borrowing of £348bn over the next two years is more than all previous governments put together and apparently equivalent to an extra £30,000 borrowing for every UK household.

Having set the scene Mr. Darling then went on to say how he intended to ultimately balance the books – a crucial part of which is to increase tax revenues. Having only recently announced a new top tax rate of 45% in last year's Pre-Budget Report, the Chancellor explained that this new rate would actually be 50% for individuals earning more than £150,000 from April 2010. On top of higher taxes, high-flyers will also see a reduction in higher-rate tax relief from April 2011 with relief being tapered down to the 20% basic rate for those earning more than £180,000. **The Sunday Times** said that about 750,000 people could be hit by the changes over the next decade according to experts, who point out that the government has said it has no plans to increase the new threshold in line with inflation. All those earning over £100,000 would also see their personal allowance reduce by £1 for every £2 income they receive over this figure. On the positive side, the Chancellor announced an increase in the annual contribution limit for individual savings accounts (ISAs) to £10,200 of which savers will be allowed to invest up to half into cash with the balance into stocks and shares. Those aged over 50 in October will be able to take advantage of the new limits whilst the rest of us will have to wait until next April.

The message of this budget appears to be clear, use pensions now - while you can, perhaps worth noting that anyone earning above £150k who was in the habit of making regular monthly contributions to a pension can still benefit from full tax relief of 40%. All 40% tax payers should take note and consider maximising their pension premiums, or risk losing it.

Even those who do earn more than £150k and who face the prospect of lower tax relief on their future pension contributions still have the same need to build up their retirement fund, only now they will have to look at all their investment options.

Outlook Getting Brighter

It was a mixed-week in economic terms for the global economy with continuing poor data emerging but this was tempered by increasing optimism. Japan announced its worst trade deficit for 30 years but exports staged a surprise recovery in March, offering a rare glimmer of hope for the world's second largest economy. Here in the UK, official statistics showed that the number of people unemployed rose to 2.1m, its highest level for ten years, as a result of a surge of redundancies. Britain's manufacturing output suffered its sharpest drop since 1975 in the first quarter of the year but the CBI said there were signs that the worst of the slump in industry may have passed. The organisation's chief economist Ian McCafferty said "The first quarter of 2009 was extremely tough for UK manufacturers but this survey shows that companies hope that the worst may be behind them, with the pace of decline slowing". Andrew Sentence, a member of the Bank of England's MPC said the UK economy is set to recover later this year with a further rebound next year but also warned that inflation could resurface as the country emerged from recession.

Looking abroad, Germany's economic prospects have brightened unexpectedly with a sharp rise in business confidence, according to **The Financial Times**. Whilst the country is still expected to be amongst one of the world's worst performing economies this year the latest *Ifo Index* of business sentiment suggests the economy is closer to returning to growth than previously thought. In Spain though there are no immediate signs of growth with unemployment rising to 4m last week or 17.4% of the country's workforce – the economy has been hit hard by the collapse in the property market. Elsewhere China's central bank said that its economy was picking up again following news that growth had slipped to 6.1% in the first quarter and was confident that growth for the year would be close to the official target of 8%. In Washington, leaders of the Group of Seven leading economies said it too saw the pace of decline slowing and also praised China's moves

to promote more balanced growth. Out on a limb somewhat was the IMF which warned last week that the worldwide slump will be deeper than first thought and says it sees no signs of recovery in developed economies next year.

A Week in the Markets

After a strong run in recent weeks it was no surprise to see equity markets take a breather last week – following news of a surge in bad debts in the first quarter of 2009 as Bank of America traders took the opportunity to bank some profits, causing a temporary wobble on global markets. However the mood improved later in the week when US Treasury Secretary Timothy Geithner assuaged some fears over the banking sector saying that the vast majority of banks had sufficient capital and would pass the Federal Reserve's 'stress test' – results of which are due for publication on 4 May. By the end of the week most major indices had given some ground but London bucked the trend where investors took economic news and the Budget in their stride, deciding share prices still offered opportunity – by the end of the week the FTSE100 had risen for the seventh consecutive week, closing at 4,155.

Against this backdrop, **The Financial Times** reported that private investors have been putting more of their money back into the stock market in recent weeks, according to research by Capita Registrars. The paper went on to discuss the merits of corporate bonds for those seeking higher returns than cash, saying their attractions have become quite clear in recent months. Yields on investment grade bond funds are around 7% gross which reflects concerns that an abnormally high number of companies will default on these bonds – the market is currently pricing in a default rate of 25%. This aspect highlights the fact that there are risks attached to this type of investment but bond analysts think it very unlikely that such a high level of defaults will actually come about. The paper's experts said that investors seeking lower risk should invest in funds that predominantly own investment.

Experts See Opportunity

Many investors will be mulling over the implications of the Budget so it's useful to have the views of the investment experts. Fund manager Edward Bonham-Carter, CEO of Jupiter, who manage funds for St. James's Place, gave his reaction to the Budget. "As we anticipated in November, the Chancellor's initial forecast for 2009 GDP growth has proved wildly optimistic. In today's Budget, he has been forced to revise it substantially. The economy is likely to contract by 3.5% in 2009, a far cry from the 1.25% to 0.75% fall projected in the pre-Budget report last autumn. Moreover, the alarming growth in government borrowing is set to continue. The Chancellor expects public net sector borrowing to be £175bn or 12.4% of GDP this year, the highest level of debt since the Second World War. To fund this spending, the Treasury now plans to issue as much as £220bn of gilts, over

£70bn more than the £148bn of sales outlined in the pre-Budget report.

So what does this mean for investors? Market reaction over the next few weeks will be crucial. If the market finds the Chancellor's assessment of the situation credible, then it should be able to absorb this massive increase in borrowing and gilt issuance. If on the other hand, investors perceive the UK economy as unattractive, they may prefer to buy the billions of dollars being issued by other recession-hit governments such as the US. Long term interest rates could shoot up and borrowing become more expensive. The picture is further complicated by quantitative easing - the Bank of England is using £50bn of new money to buy government bonds until the end of May. Moreover, many believe the financial crisis is not over. The IMF has warned that banks have only written off about a third of prospective losses and could have to raise another £85bn to mend their balance sheets. Together these factors add up to yet more government borrowing. And to pay for all this debt, the government will need to curb public spending and further increase taxes. The latter could potentially hobble a recovery when it comes.

Shares are therefore likely to be volatile for some time. For example, in the last six weeks, we have seen a considerable rally led by financials and other cyclical stocks, and this has led to talk of a recovery. However, we remain cautious. Nonetheless, a lot of bad news has already been priced in to markets and one is, in my view, starting to be paid for taking the risk of investing in equities on a three to five year time horizon. In such an environment, it is understandable that some investors, who have seen stock market indices return to 1995 levels, may feel frustrated with equity investing. However, it is worth highlighting that while indices may have moved sideways in the past 10 years, the UK's best active fund managers have been able to make money during this period. One would expect that many will be able to do so, even if indices continue to move sideways, over the long term. Investors should also bear in mind that in such market conditions, averaging in exposure to the markets using regular savings schemes is particularly attractive for those investors who do not have a short-term requirement for cash.

The other significant question for investors is where they can get their income from. With interest rates in many countries at historic lows, investors' income will have dropped to critical levels. To achieve higher incomes, investors will have to take more risk. Given that the credit crunch has exposed many complex "manufactured" products as flawed - with capital often being sacrificed in pursuit of income - investors are more likely to seek out traditional income products, such as corporate bond funds and equity income funds. To that end, I welcome the Chancellor's decision to raise the ISA limit from £7,200 to £10,200".

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