

## Tax and Cut

Autumn has arrived, bringing with it the start of a very interesting party conference season. With the General Election less than a year away the Labour Party will gather in Brighton later this month to plan how to win a fourth term in government after what has been quite an extraordinary year. The country has experienced the worst financial crisis since the Great Depression. A crisis which led to a near collapse of the UK banking system, took us into a severe recession and caused a sharp rise in unemployment. The Government's remedy has been to flood the economy with liquidity in an attempt to stave off deflation and reflate our flagging economy. We saw interest rates slashed to historic lows last October, our banks effectively being nationalised and in the Spring the introduction of Quantitative Easing - printing money. These unprecedented measures are now beginning to stimulate the desired green shoots of recovery. There will, however, be a heavy price to pay for a sustained recovery. We have already seen the pound being devalued and should fully expect to see inflation longer term as the National Debt builds. To balance the Nation's books the taxpayer will be footing the bill with tax rises and cost cutting. Indeed, we have already seen this start:

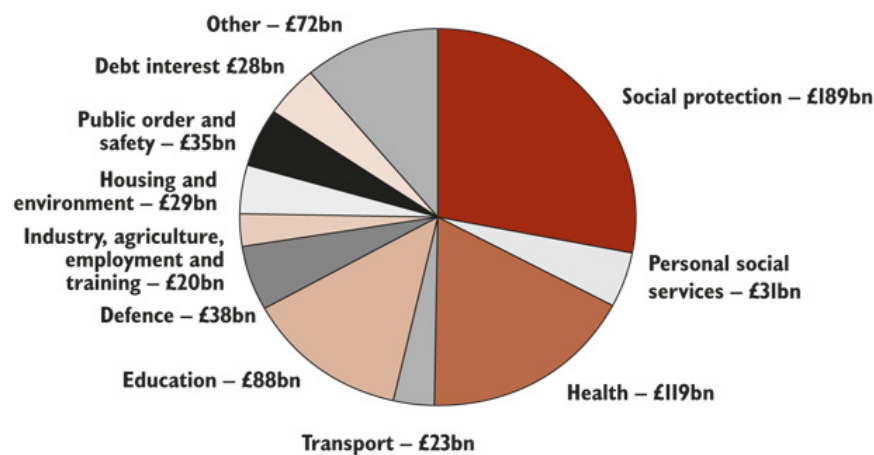
- fuel duty has been increased by 2 pence per litre as of 1 September 2009, and will increase by 1 penny per litre in real terms each year from 2010 to 2013.
- the thirteen month reduction in VAT will end 31st December 2009 and then will return to the previous rate of 17.5%.
- from April 2010, an additional rate of income tax of 50 per cent will apply to income over £150,000 and the income tax personal allowance will be restricted for those with incomes of over £100,000.
- from April 2011, tax relief on pension contributions will be restricted for those with incomes over £150,000 and tapered down until it is 20 per cent.

If raising taxes is unpopular, then there is more to be lost on cutting public spending. According to this year's Budget total public spending is expected to be around £671.4 billion this year, around £10,900 for every man, woman and child in the UK. The chart below shows how the budget is spent, with half of the money used to fund unemployment benefit and the National Health Service. It is unlikely that these two departments will suffer too much from cost cutting

with education and defence being the more obvious targets. There is already talk, in the weekend newspapers, of the Government's plans to save £2 billion on education. It will not be long now before the Government begins to spell out exactly what cuts and savings they plan to make.

### Chart I.I: Government spending by function

Total managed expenditure: £671 billion



Source: HM Treasury 2009-10 near-cash projections. Spending re-classified to functions compared to previous presentations and is now using methods specified in international standards. Other expenditure includes spending on general public services: recreation, culture, media and sport; international cooperation and development; public service pensions; plus spending yet to be allocated and some accounting adjustments. Social protection includes tax credit payments in excess of an individual's tax liability, which are now counted on AME, in line with OECD guidelines. Figures may not sum to total due to rounding.

Whilst the governing Labour Party is looking to convince us that they deserve a fourth consecutive term in office, the Conservative Party will be seeking to regain the majority they lost in 1997. They will meet in early October in Manchester to plan how they will convince voters of their manifesto to replace the governing party. But this is a manifesto which will surely be unable to avoid increasing taxes and cutting public spending. For their part The Liberal Democrats will gather in Bournemouth and they too have been talking tax hikes and bold cuts. They will be hoping to take votes from both sides in the next General Election. Whilst they would, of course, ideally want to form the next government, a more realistic outcome would be to hold the balance of power in a hung parliament.

Whatever the outcome of the next election, there is no doubt that voters in the UK must now accept increasing taxes and cutting public spending as inevitable. The Party that wins will be the one that can convince the electorate that they are the most capable of making the right choices to sustain an economic recovery. This is a similar campaign to 1992 when the economy was in a

recession and against all odds the Conservative Government under the leadership of John Major managed to retain power. This time round trust and confidence will be the key factors determining who takes the keys to No. 10. The MPs expense scandal tarnished the reputation of parties on both sides of the House. Whilst Party leaders urged their members to put right any wrong doing, the integrity of our politicians was delivered a severe blow. There have already been many casualties and no doubt there will be many more when MPs stand for re-election next year.

The next general election must be held on or before Thursday 3rd June 2010, with the present parliament expiring at midnight on 10th May 2010. Local elections take place on 6th May 2010 and some have suggested that the general election may also be held on this day. The best outcome for the economy would be a majority allowing tough choices to be made in the early term of a new government. The worst outcome, and one commentators are beginning to talk about, is a hung parliament which could potentially have a disastrous effect on the British economy.

The outcome of the next election will shortly become a concern for investors. Stockmarkets are forward looking and will be impacted as investors fears increase about what will happen in the future. The rally in the market which started in early March was based upon the perceived outcome of the recovery plan rather than any real green shoots. This rally gathered momentum with the concerted efforts of governments and central banks around the world, as well as the announcement that a policy of Quantitative Easing was to be introduced. It is unlikely that the authorities will begin to withdraw the liquidity supporting the global financial markets anytime soon. To do so too early would risk the recovery and prolong this recession.

The most visible measure of liquidity is interest rates. We believe interest rates will remain low for some time. This might be a delight for those with mortgages and high levels of debt in employment but is bad news for savers. They are still being forced into risk assets as they seek greater returns than they can achieve on their cash deposits. The excess premium yield on corporate bonds compared to ten year gilts remains attractive. Perhaps the "once in a generation" value that we saw in corporate bonds at the beginning of the year has now started to disappear but there is still plenty of value to be found at this stage of the credit default cycle. With the lack of willingness by banks to lend, many companies are turning to the bond markets

to raise cash. Most bond fund managers we have spoken to lately are increasing their exposure to the high yield market as the default cycle starts to peak. In this sector the key to generating superior returns, in the future, will lie in picking the right credits and having the right tools to reduce maturity and interest rate risk. For us this is best found through strategic bond funds that can employ a flexible approach.

Aside from the credit markets, UK equities are also offering a generous yield premium to ten year gilts. Whilst there is some uncertainty over dividends, there is the potential for capital growth. The more secure dividends are to be found in the larger companies, however, there is a danger that the market ignores these income stocks in favour of growth. Whilst, the economy is showing signs of a recovery, future growth will be muted as households, corporates and the government reduce debt. Companies have recently improved profits, but this has been more as a result of cost cutting as opposed to growth of revenues. Unemployment and consumer confidence always lag in a recovery and we see no reason why it should be any different this time. If this is the case, then growth companies which can outpace the economy, will be the favoured ones. In this type of market buyers focus on growth rather than valuation. In this environment value managers will underperform.

This focus on growth has also been highlighted by the difference in the equity returns from Developed and Developing Markets. The West has been constrained by increasing debt and the prospect of higher taxes and fiscal tightening. On the other hand, Developing Markets, particularly those found in Asia Pacific and Latin American regions remain in a stronger fiscal position as they are able to fund future growth through savings. This division looks set to widen further as we witness the gradual wealth transfer from West to East. The next ten years will see this trend accelerate as the least indebted nations maintain their growth path. Our current preference is for the BRIC countries (Brazil, Russia, India & China) which have strong momentum in growth and maturing economies. These are also the countries which Goldman Sachs believe will have the biggest impact on the global economy in the future due to their strong population growth coupled with their open markets.

The continued growth in Developing Market economies also supports commodity markets, but at the same time weakens the US dollar. The thirst for energy and industrial metals will drive prices higher in the long run. The oil price has risen to the US\$70 level which is less than half its

price last summer. The increasing burden of debt and the fact that US investors are now looking for better value overseas is weakening the US dollar. A gradual slide in the US Dollar will suit the authorities as it will reduce their debt and encourage exports. However, with the consensus forecasting that interest rates will stay lower for longer, there is a danger that the US Dollar will become the carry trade currency as the Japanese Yen was in the last bull market. This weakness, coupled with the long term fear of inflation has promoted Gold as a serious alternative for those wishing to diversify away from holding US dollar assets.

In my experience as an investor for over twenty years, there are many times where you have to hunt for opportunities, but this is not the case in today's markets. Central banks and governments have stated that they are maintaining their loose monetary and fiscal policy stance to insure that the recovery is sustained. Withdrawing liquidity gracefully when the economy is back on track is only a future concern rather than an immediate problem. All this is very supportive for risk rather than risk free assets. We do not wish to imply that it will be plain sailing from here on out as there are still many clouds on the horizon, but it is fair to say that we can see a silver lining. It is quite understandable that for many investors, just a year on from the beginning of the credit crisis, their main thoughts are still on how to avoid losing another 10%. For us, it is about thinking about where we can make the next 10%!

**John Husselbee**

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**21<sup>st</sup> September 2009**

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