Who will lend us the money?

December 2009

We entered 2009 with fears for the financial markets and the capitalist system: so to be pouring cold water on the so called recovery in markets might appear disingenuous.

The fact that I believe we are potentially in as bad a position as 12 months ago has meant I've not enthusiastically embraced the booming stock market. My prediction is that 2010 is going to be a difficult year for the UK economy, government debt and therefore sterling.

Government finances are on a knife edge: everything depends on the international markets. Will they step in to buy UK gilts at current prices when the Bank of England stops buying?

The enormous stimulus provided by governments to try to get banks lending again had to go somewhere, and the result has been asset price inflation. Only a tiny proportion of the funds have trickled into the private sector with the vast majority staying on banks' books to help them rebuild their balance sheets.

The best outcome would be if the banks lend this wall of money to people who invest in businesses, employ more staff who in turn buy goods, etc. This will lead to sustainable growth and justification for the strength of the stock market rebound.

Modern Economics

It is decades since there has been such a debate into the course of economics with the Keynesian view of using government stimuli to fill the lost economic output currently winning the day. However, the other camp of those arguing for the faster control of public expenditure may well be seen to have won the argument when the history books are written.

Nowhere is this argument more damaging that the public spat between Mervyn King, Governor of the BoE, and Alistair Darling the Chancellor.

What we don't know is the effect the ending of Quantitative Easing (QE) will have on the UK economy. Looking at the gilt market there are some alarming indications.

Gilts

Gilts are bonds or debt issued by the UK government (in the US they're called Treasury Bonds) to finance the difference between revenue (taxes) and expenditure (public spending). The table below shows the gilt redemptions and issued by the Government from 2001 – 2014. Source www.dmo.gov.uk.

Fiscal Year	Gilts Issued £bn	Gilts Redeemed £bn	Fiscal Year	Gilts Issued £bn	Gilts Redeemed £bn
2001/2	£13.7	£17.9	2007/8	£58.5	£31.4
2002/3	£26.3	£18	2008/9	£164.5	£19.2
2003/4	£49.9	£20.6	2009/10	£130.5+	£16.6
2004/5	£50.1	£15.8	2010/11	?	£38.9
2005/6	£52.3	£14.3	2011/12	?	£49.2
2006/7	£62.5	£30.6	2012/3	?	£44.3

+ 8 months to November 30th 2009

The increase in gilt issues in 2008-9 to £164.5bn shows how dramatic the deterioration in government finances has been and over £130bn has already been raised so far this year.

Over the next few years, not only will the public sector borrowing requirement include the revenue shortfall but also a further £40bn+ of gilt redemptions (maturing) each year. Who is prepared to lend the UK all this money?

This is where Quantitative Easing comes in. The Bank of England have obtained permission from the Government to create up to £200bn of new money by QE, and what are they buying – gilts. So there is this 'happy' circle of the BoE being a major purchaser of gilts which is why bond yields are so low: the BoE now own 20% of the gilts in issue.

Who is going to fill the void if and when the Bank of England stops buying gilts? If no one is prepared to, then the UK will be technically bust and have to go to the IMF for help.

A cynic might expect that the probability of QE being maintained until after the General Election is very high since its removal could lead to a funding crisis, just at the wrong time for the government

Investment Outlook

I believe investors can't ignore the risks associated with government finances in the US, UK and also Europe. There are only three options ultimately to get finances back on track, pay the debt, default or inflate it away.

Throughout history, governments have used the latter option and this is why gold has recently hit a new high as investors look for assets which have *real* value.

In my view, a buy and hold equity strategy is extremely risky in the current environment as we just don't know what the outcome will be from the differing economic strategies being pursued.

For the last few months, the FTSE100 has traded in a narrow range of 5000-5400, just as it did from October 2001 to May 2002. When it broke out of the range (then downwards) the move was rapid as it could be this time – but which way!

In my view, whether the rally in asset prices can be maintained depends on how economies adjust to an exit from Quantitative Easing.

If the debt can be financed at or around current bond yields, equities could hold up, but if governments are forced to balance the books more quickly we will have a double dip recession and further pain.

As I said in June 2007, investors can either try to ride the current stock market upwave or sit on the sidelines and wait for something which might never happen. It did after June 2007 but it may not now - I think it will!

The most difficult decision investors face is what alternative is there to either cash which is yielding next to nothing and equities which are often yielding much more than cash but carry a lot of risk. At least in June 2007, you could get a decent return on cash.

Here, the themes expressed in my last newsletter are still very much in favour: index linked gilts as a hedge against inflation, global government bonds for security in global currency terms and selected managers who proved their capability through 2008 – and of course gold!

In that newsletter, I expounded the long run benefits of Asia and Emerging Markets, markets which are not exposed to the levels of debt in the G7 countries. Future portfolios will need to strongly represent established companies in these markets as well as growth companies who are developing new technologies. The target should be to have up to 20% in these markets within the next 2-3 years.

INDIVIDUAL SAVINGS ACCOUNTS

From April 2010 there will be a change to the limits on ISAs and some significant changes in the relationship between Cash and Stocks/Shares ISAs.

Currently, there are two separate ISA products, a cash ISA and a Stock and Shares ISA. If you invest in both in a given tax year, they are called mini ISAs and the maximum into each was £3,600. Alternatively you could invest £7,200 in one maxi stocks and shares ISA.

To add to the confusion, a stocks and shares ISA can invest in corporate and government bonds as well as shares. This enhances the tax benefits because the tax on the interest (20%) is reclaimed whereas the tax credit (10%) on share dividends can't be.

From 2010 the limit on ISAs is increased to £10,200 with the limit on cash ISAs £5100: but now you can invest less than this in cash and increase the stocks and shares content: eg you continue to invest £3600 in a mini cash ISA and place all the rest of your allowance £6,600 in stocks and shares.

From the rules which started in April 2008, it is now possible to transfer cash ISAs to Stocks and Shares but not the other way.

Finally, for anyone over 50 before April 5th 2010, these new limits came in on October 1st 2009 so it is possible to take advantage of the new rules from now.

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Finally may we wish you a very prosperous 2010!

ALISTAIR THOMSON

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