

"I know nothing stays the same, but if you're willing to play the game, it's coming around again" Carly Simon



Pensions Re-simplification?

We were recently fortunate to attend a meeting at the House of Commons courtesy of the Tax Incentivised Savings Association (Tisa), where the guest speaker was Vince Cable MP, Liberal Democrat Shadow Chancellor.

His economic views on the current crisis are well respected (unlike most politicians!) not least because he was one of a small band of people who predicted the 'credit crunch'. He is a keen supporter of encouraging savings in the UK and wishes to see the end to means tested pension benefits, compulsory annuitisation and complex secondary pension legislation, all of which help to 'de-incentivise' savers.

His speech provided the audience with much confidence in the future, not least because he was at this function as a guest of Conservative MP Howard Flight. This demonstrates that behind the electioneering and lurid press articles, there is a great deal of consensus from the main parties on where we need to be and how to get there. He also does not see the current national debt and other concerns such as the state and superannuation pension black holes as insurmountable.

It was also pleasing to hear that last week the Treasury has accepted 'in principle' pension proposals from Tisa to reduce the annual allowance and restore higher rate tax relief. Tisa director of retirement planning Malcolm Small believes it has enough support for its pension reforms to see it become Treasury policy later this year.

The proposals challenge the Treasury decision to taper higher rate pension relief to 20% for those earning £180,000 from April 2011. Tisa's alternative is to reduce the annual allowance to £50,000 from the current £245,000 and restore tax relief, which Small said would cost the Treasury £3.2 million a year less than its planned move and would hit those earning £150,000 a year and over more directly. The Tisa plans will also negate the need for anti-forestalling measures put in place by the Treasury .

However, Tisa is not expecting the proposals to form part of the next Budget - expected at the end of next month - but to be included in a second Budget that will take place after the general election.

"If you would be wealthy, think of saving as well as getting." Benjamin Franklin (1706 - 1790)

Down, Down?

Most of us do not need the Office for National Statistics to tell us that prices are going up and that living standards are falling. We see it every time we visit the High Street, or take a trip to the supermarket, or fill up our cars. We also see it when we open up our bank statements and see the miserable return that passes for interest these days.

Still, it is shocking to see that consumer price inflation (CPI) was 3.5% in January, up from 2.9% in the previous month - the largest monthly increase ever and retail price inflation (RPI) - which excludes housing costs - up from 2.4% to 3.7%. Remember, the Bank of England is mandated to keep CPI at 2% or 1% either side 'at all times' and only a few months ago it was warning of imminent



deflation. However these numbers are of little surprise and are certainly no worse than expected - given the hike in VAT in January.

Inflation should begin to fall over the coming months, though by how much no-one is quite sure. However, questions remain unanswered such as how temporary is the latest increase? Is the Bank of England right to suggest that medium-term inflation remains on target?

The current level of inflation is being blamed on three factors: the VAT increase; rising oil prices and the depreciation of sterling. The MPC predicts that these factors will quickly subside and in the medium-term they remain convinced that 'supply capacity' in the economy will push down on prices. For that reason its central medium term forecast remains much as it did a year ago, though Mervyn King has been forced to admit that short-term inflation will be more volatile than predicted. He also states that such downward pressure is already evident in the labour market and in consumer spending data.

Others, however, are less sanguine. They point to the fact that core inflation has been much more stubborn than expected over the past year and that much of the effects of quantitative easing and the depreciation of sterling are yet to fully feed through to prices.

As a hedge against possible rises in inflation you might consider the 19th Issue of National Savings Index Linked Certificates. This is a 3 year investment paying Tax Free interest of 1% over RPI for each year. So if RPI stays at 3.7% this first year would see a tax free 4.7%. Look around at deposit account rates and this is very attractive. The maximum investment is £15,000.

Corporate bonds: Beware the tail-risks

In 2009 corporate bonds delivered remarkable gains. With double-digit returns typically reserved for the likes of equities rather than (normally tranquil) bonds, credit markets have attracted a steady flow of investors. Following such a stellar performance, however, what can investors expect in 2010?

Such a performance was only made possible by the panic that transpired during 2008, which pushed corporate bond prices to extreme lows as investors fled to the safety of government bonds. Importantly, this panic affected a broad spectrum of corporate bonds, not only those at risk of downgrade or default. Even bonds issued by highly-rated, global companies with strong revenue generation and ample liquidity (i.e. as bullet-proof as corporate bonds get) suffered significant weakness *just through panic*.

As a result, investors could have generated significant returns over the course of 2009 by employing a relatively cautious investment strategy, by sticking with the safer names and avoiding the risky ones altogether. The lowest-rated investment grade corporate bonds (BBB) generated a huge 27.3% total return, whilst the relative safety of AA corporate bonds still posted a 10.9% return.

In 2010 corporate bonds are likely to return to producing mainly steady yield and little in price movements. It is clear that the yields on offer at the safer end of the corporate bond universe are no longer as attractive. However, the volatility of the past couple of years has left the market in a vulnerable position and it would not take much to knock it from its current recovery. The potential risks in the coming months are as follows:



Risk 1 - Economic boom

A strong economy may seem a strange risk scenario. However, it is the impact on inflation and interest rates of growth moving too fast, too soon. Policy makers are likely to keep interest rates low, until the recovery is staring us in the face: leading to an aggressive recovery, asset price appreciation, a commodity bull market, ultimately higher inflation, and thus higher interest rates- bad news for corporate bonds.

Risk 2 - Economic double dip

The most likely set back to growth would be consumer related. Companies are currently in reasonable health, having cut costs and controlled debt throughout the recession. The consumer that took on too much debt via credit cards, auto loans, mortgages etc, may be hit again if we suffer a further economic set-back .

Risk 3 - Sovereign credit risk

Sovereign credit risk has now come to the fore, as by cutting interest rates, nationalising banks, guaranteeing retail deposits and subsidising consumer spending, a significant amount of debt has been transferred from private institutions to government balance sheets. This trend is being replicated across the globe, and it is unlikely to end any time soon.

In contrast to 2009, playing it safe will no longer provide *exceptional* corporate bond returns in the coming months. We believe corporate bond investors can continue to benefit from good returns in 2010 *through yield*, which is still likely to be better than cash, but significant capital appreciation is unlikely.

"The national budget must be balanced. The public debt must be reduced; the arrogance of the authorities must be moderated and controlled. Payments to foreign governments must be reduced, if the nation doesn't want to go bankrupt. People must again learn to work, instead of living on public assistance. " Cicero (106 BC - 43 BC),

Government Debt - when to start reducing?

If the dangers of running large and persistent budget deficits are known, can we expect politicians to 'do the right thing' and to make sharp reductions in deficits once the economic recovery is more certain? One of the reasons for the bond market's nervousness is that, on this, the signs are mixed.

In Greece, strikes by public sector workers, demonstrates the difficulty facing governments that try to reduce public spending. Yet at the same time, Greek Prime Minister George Papandreou continues to achieve a high approval rating. In the UK, the Conservative Party is promising unspecified spending cuts to reduce the public deficit ahead if it wins a general election in the spring.

In the US, President Obama's budget projections suggest a continuing rise in debt to GDP ratios, from 53% in 2009, 73% in 2015 and 77% by 2020. Undeterred by these debt ratios, in February the president announced proposals for a second stimulus package, of around USD 270 billion. Yet voters in the US have begun showing dissatisfaction with the huge growth in deficit spending under President Obama

A new branch of economics, called social choice, looks explicitly at the relationship between voters, politicians and economic policy. A student of this school might say that *we get both the politicians and the deficits that we deserve.*



While economists and politicians may be able to find reasons to prolong the fiscal stimulus policies, principally due to the fear of a double dip recession, the bond market is not so patient. It wants answers now, not tomorrow, from governments as to how they intend to curb the rapidly increasing issuance of sovereign bonds. The bond market's worries may be focusing on Greece and the so called *iPIGS* at present but the major sovereign issuers are also at risk of being sold off if cyclical deficits appear to be becoming structural.

Investment themes for the new decade (3) - Emerging market sovereign debt

 Brazil,  Hungary,  Mexico,  Poland,  South Africa,  Taiwan,  China etc

Following on from the last article there is a potential investment solution arising from the government deficit problem.

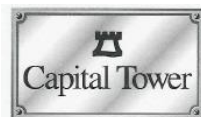
The fiscal positions of the leading emerging economies are much healthier than those of the developed countries. Indeed, while developed countries face threats of downgrades from rating agencies, the average rating of the constituents of the Emerging Market Bond index is rising.

Faster economic growth, smaller deficits and better demographics all support a move away from developed market and into emerging market sovereign debt, a factor that will be given full consideration in future client portfolio reviews.

SUMMARY

"Until and unless you discover that money is the root of all good, you ask for your own destruction. When money ceases to become the means by which men deal with one another, then men become the tools of other men. Blood, whips and guns--or dollars. Take your choice--there is no other. "Ayn Rand (1905 - 1982), Atlas Shrugged

Although the short term direction of the UK economy and markets in 2010 is uncertain there is a bright future ahead and we remain *Cautiously Optimistic*. The key to a successful investment portfolio remains diversification; and we continue to research the global markets to ensure our clients are in the right sectors.



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