Get Well Soon!

Low growth and high inflation - the UK economy maybe out of the emergency room but we are still in intensive care. The huge cost of rescuing the economy from recession and bailing out the banks has left a massive hole in the nation's finances. The medicine required to reduce the deficit is austerity which means cutting government expenditure and raising taxes, helped along the way with a spoon full of sugar - low interest rates. For some time now, even with this sweetener, the economy has been finding the medicine a little too hard to swallow which has prompted critics of the Coalition's plan to question the amount as well as the fairness of the distribution of spending cuts and tax rises. However, I am yet to be convinced of any alternative medicine than will work.

Our Nation's finances are not that dissimilar to those of the Portuguese, the Irish and the Greeks, all of which have been bailed out in the past twelve months. These countries are all in the Eurozone where the responsibility for setting interest rates and as such the exchange rate via the single currency is controlled centrally by ECB (European Central Bank.). Fiscal policy on the other hand as in how much each country spends and how much they raise taxes, is left in the hands of each member state. Until the global financial crisis, all Eurozone countries enjoyed the same cost of borrowing, any past history of poor repayment was overlooked. This is not the case today and the weaker Eurozone members have seen the cost of their borrowing soar to an unsustainable level. With the benefit of hindsight the proposed bailouts were inevitable, as the alternative of sovereign default has been politically unpalatable.

However bailouts are not the solution, these are simply a temporary fix whilst something more permanent is worked out. For those countries accepting a bailout there is a hefty price to pay. Firstly, there is the loss of their fiscal autonomy - the right to manage their own finances. The government has had to persuade their people, their voters, to accept a severe austerity package and the consequential reduction in their standard of living. Secondly, there is the prospect of weaker

economic growth - the ability of any country to service and repay their debt depends upon the growth of their economy, as tax revenue needs to be at least maintained to pay back their creditors. Whilst, austerity packages reassure bond holders, consumers and businesses become more cautious about spending so consequentially economic growth weakens. Squeezing more tax revenue out of a shrinking economy is a challenge. In the past, Portugal, Ireland and Greece have devalued their currencies to encourage export growth. Devaluing the Escudo, Punt and Drachma is no longer an option, they are all part of a single currency where exchange rate policy is controlled by ECB. The Euro has been a relatively strong currency and this month's hike in interest rates to hive off inflation fears will not help foster economic growth.

In the UK we have an advantage because we have more control over both our monetary and fiscal policy, although this is still limited by the wishes of our bond holders. Sterling has been devalued, in line with the plan to replace consumer spending for export growth. Whilst the competitiveness of our exporters has greatly improved, import prices have also dramatically increased with a weaker pound. The other major part of the Government's fiscal consolidation plan, is to encourage the private sector to replace government investment as the proposed spending cuts start to bite. Investors should expect to see looser regulation and more tax incentives for both new and existing private enterprise to promote this initiative.

For all the autonomy we have to manage our own public finances, there has been a cost in lower economic growth and higher inflation. Inflation remains stubbornly above the Government's 2% target and is considerably higher than most other developed economies. Whilst every part of the global economy has seen inflation rise as result of soaring commodity prices, inflation in the UK has taken on the additional price changes due to the increase in VAT and a weaker pound. The MPC (Monetary Policy Committee) at the Bank of England, which has the role of setting UK interest rate policy, has repeatedly stated that they believe the above target inflation is only temporary. It is clear from the recently published minutes of their last meeting that they are a long way from raising interest rates particularly with no signs of wage inflation given the high unemployment numbers. It seems

to me that interest rates will only begin to rise either when we see a pick up in wage inflation or we experience a couple quarters of higher than higher economic growth. Until then household incomes will continue to be squeezed by low returns on cash deposits and increases in the cost of living. With the consumer representing almost two thirds of economic activity, this means weaker growth for the foreseeable future.

This weaker economic growth has clearly been reflected in lower Gilt yields in the last quarter, in recent months the yield on ten year government debt has fallen from around 3.8% to close to 3%. However these falls have exceeded my expectations and begs the question are there other factors at play here. It can be no coincidence that the fall in Gilt yields has occurred as Eurozone government bond yields in the weaker countries have soared over renewed fears of a sovereign debt default. This seems to support the fact that that bond investors still consider Gilts to be a safe haven and approve of the Government's handling of the UK economy. Or, perhaps, maybe there is a belief that we will see further quantitative easing should weak economic growth persist.

When looking at the UK economy it does seem that it has lost steam over the last year. Some commentators are saying that this is only to be expected following a major financial crisis, however there has also been a weakening in the global economy following the supply chain issues caused by the Japanese earthquake and tsunami as well as the spike in commodity prices. The resultant weaker global trade has delayed the expected boost from a lower pound. For my part, I am not in the deflation and further recession camp at this stage, I believe that Gilts are a very expensive asset to own and that equities will offer far greater value over the coming year, however I am cautious in the very short term as investors focus on the plight of sovereign debt in the Eurozone. Furthermore I believe that economic weakness also threatens the longevity of the Government's austerity plan which is not only based upon spending cuts but also on increasing tax receipts from a growing economy. I am not sure that Plan B, one which necessitates a slower pace of fiscal consolidation, will work as I believe that bond investors will not continue to lend at the current low levels of interest rates. The

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real fear is that a policy error may send our fragile recovery into another recession and straight back to the emergency room.

John Husselbee

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