

Comment

BUDGET 2010

“Annual income twenty pounds, annual expenditure nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pound ought and six, result misery”

Mr Micawber, David Copperfield - Charles Dickens (1812-1870)

- ***Neutral budget as expected***

The Chancellor, Alistair Darling, was expected to announce a reasonably neutral budget and he lived up to expectations last Wednesday. The speech could best be described as a party political broadcast that lacked any detail. We believe it was a non-event as it failed to recognise the economic challenges facing the government. With the budget deficit forecast to be £163bn in 2010/11, there was little chance of the Chancellor being able to increase borrowing further for any pre-election giveaways nor was there any likelihood of meaningful budget cuts given the imminent General Election. This was an opportunity for both Mr Darling and Mr Brown to give a vision of what lies ahead for voters should Labour be re-elected for another five years, but the overall message was for a gradual debt reduction through economic growth rather than by meaningful spending cuts or tax changes.

- ***Lacking in detail***

- ***No meaningful spending cuts***

- ***Economic growth forecasts are too optimistic for 2011 onwards***

The UK economy has only just emerged from recession, with recently revised GDP growth of 0.3% reported for the final quarter of 2009. The Chancellor has forecast GDP growth of 1.25% for 2010 and 3.25% for 2011, which is higher than most independent expectations. The GDP growth forecast of 3.25-3.75% p.a. from 2012 is very optimistic in our view, particularly given the lacklustre growth rate forecast for this year.

- ***We remain anxious about inflation***

In contrast to last year, inflation has been rising and the CPI index is currently at 3.0%. This means that inflation is still significantly ahead of the Bank of England's inflation target of 2% although the February number was below January's 14 month high of 3.5%. The broader RPI index held steady at 3.7% in February. The Chancellor expects inflation to remain above target in the short term, reflecting the impact of the VAT change but it is then expected to weaken and reach 2% by the end of 2010. Inflation is forecast to be below the target rate throughout 2011 at 1.5%. As we have highlighted previously, economic history would suggest that inflation is more likely to re-emerge over the longer term, particularly if economies continue to recover.

- ***PSBR forecast to reduce only slightly next year***

Public sector net borrowing in 2009-10, although now estimated to be £11bn lower than forecast in the 2009 Pre-Budget Report due to higher than expected tax receipts, is still an extremely large and worryingly high number at £167bn. In 2010-11, net borrowing is forecast to fall slightly with a more meaningful reduction to £131bn the following year. However, to put the debt level into perspective, this will lead to a near doubling in our national debt over the next five years to £1,406bn, equivalent to £57,000 for every British household. In 1997, when Labour came into power, the national debt was around £350bn.

- ***Gilt issuance still at high levels***

The Government plans to issue £187bn of gilts in 2010-11, a reduction from the forecast record of £228bn in the current year although the bulk was taken up via 'quantitative easing'. There will be a proportionately higher issuance of long-maturity and index-linked gilts, helpful for UK insurance companies and pension funds as they have a strong and structural demand for these gilts. Large though these numbers are, the market expects that these gilt sales can be absorbed. The average term to maturity of the UK's outstanding debt, at 13.5 years, is the longest of the G7 countries. This reduces refinancing risk (i.e. the risk that the Government cannot roll over existing debt effectively as it matures).

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- **New higher income tax rate comes into effect**
- **ISA limit £10,200**

As previously announced, a new income tax rate of 50% will come in from April along with the withdrawal of personal allowances for those earning over £100,000. From 6 April 2010, the ISA limit will be £10,200 for all ISA investors. Thereafter, the ISA limit will be increased annually in line with inflation. There were no changes to the allowances below compared to 2009-10 but note that the Chancellor has frozen the inheritance tax allowance until 2014-15. The only tax change worth highlighting was the announcement of a two-year relief from stamp duty for first time buyers of residential property costing up to £250,000 which was offset by a 5% rate of stamp duty for homes bought for £1m or more.

Main Reliefs & Allowances **2010-11**

Personal	£6,475
CGT Annual Allowance (individuals)	£10,100
CGT rate (individuals)	18%

Income Tax Bands

Basic Rate (20%)	0 - £37,400
Higher Rate (40%)	£37,401 - £150,000
Additional Rate (50%)	Over £150,000

Inheritance Tax

Threshold	£325,000
Rate Above Threshold	40%

- **Conservatives believe more spending cuts are required**

Over the past year, we have had many announcements of support for the banks and other Government efforts to stimulate the economy. The Chancellor is now stating that its efforts have been successful in 'securing the recovery' (the title of the 2010 Budget Report) but we believe it is much too early to claim victory. Public expenditure cuts are a necessity for meaningful budget reduction, but the forecasts of public spending growth albeit at the slower rate of 0.8% a year on average from 2011-12 to 2014-15 are still too high. The Chancellor would argue that the recovery is too fragile to cut spending now but the Conservative Party has advocated that more aggressive spending cuts are needed. The Conservatives have not yet said how the cuts are to be made but have plans to hold an emergency budget, if elected, within 50 days of taking office. Irrespective of whoever wins the election, we know that the *real* budget yet to come will involve much more pain and we will no doubt be writing to clients once again with details of this.

- **Election result key**

Our conclusion is that this Budget Report contained no surprises, with the overall message of 'tax the rich and help the poor' being the same as before. Hidden within this Robin Hood budget are tax increases such as the rise in national insurance contributions due to come into effect from April 2011, referred to as a 'tax on jobs'. All eyes will now turn towards the General Election. The prospect of a hung parliament would be bad for sterling in the short term. Whatever the election result, the UK economic recovery will still be lacklustre compared to many other developed countries and the sheer size of the budget deficit and national debt remain the major issues likely to influence the prospects for the economy for some years to come.

Investment Conclusion

- **Investment strategy favours overseas earnings**

Overseas and emerging equity markets continue to offer superior growth prospects. With increased volatility, we believe that owning broader and more diversified holdings in UK companies with high overseas earnings is our preferred investment strategy. International investment trusts also have obvious appeal.

Disclosures

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