

UK Fiscal Deficit

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Ledgers have been used throughout centuries as a way of keeping track of money coming in and going out. Old paper-based ledgers, of course, have been replaced electronically (and those from the early days of C. Hoare & Co. now adorn the bank's corridors).

“Balancing the books” and ensuring an effective flow of capital are still valid today, but a number of governments are finding it increasingly difficult to balance their finances. With a general election approaching, we weigh up the prospects for the UK to reduce its national debt.

Ratings agencies have voiced concerns about the current and forecast growth of the UK's already sizeable fiscal deficit. While we expect the sovereign AAA ratings to be upheld, returning the debt burden to normally acceptable levels will take considerable time, and there is a high risk of policy error along the way. Possibly even more important for investors are the effects these developments will have on key markets.

To put the situation into perspective, cumulative net debt is forecast to rise to nearly 90% of GDP by March 2014, from just over 60% currently. The growth of the debt could be substantially worse than European peers, but broadly similar to the US.

In a historical context, high public sector debts are not that uncommon and, indeed, have been much greater. The debt rose to 156% of GDP in 1784 following the Carnatic Wars in India, the Seven Years' War against France and the US War of Independence. The Second World War resulted in the debt soaring to as high as 238% of GDP.

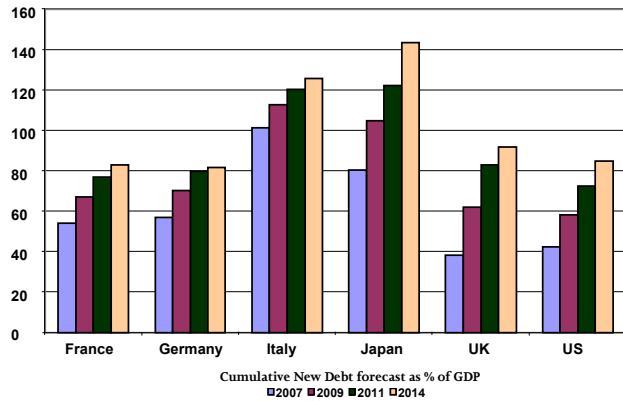
It finally fell to 25% by 1992 on a combination of factors: rising inflation, strong economic growth following WWII, the demise of the British Empire with subsequent reduction in obligations, and large privatisations under the Thatcher government.

It is worth noting that, during the last century, the government used the national debt not only to finance war efforts, but also to fund public services and mitigate economic troubles. These additional uses clearly have implications on today's debt level. We can infer from Public Sector Net Debt figures published in September 2009 that financial interventions contributed around 39% of the increase in net debt over the past three years. The government has excluded these interventions on forward-looking calculations, because it views them as temporary. However, although the nationalisation of two banks and the acquisition of substantial stakes in two others are backed by assets, the recovery rate is somewhat unclear. In addition, the cost might increase further, given contingent liabilities related to the financial sector (e.g. the Asset Protection Scheme).

The cost of interventions, however, is only part of the story, and a study of government receipts and expenditure helps explain much of the rest. In 2001-02, the two sides were broadly in balance, at 37.7% of GDP, but while receipts peaked in 2007-08, expenditure has continued to grow year on year. The gap between the two, therefore, has grown dramatically since the onset of the recession. Financial services, real estate and construction comprise a large portion of the UK economy, and are not expected to recover to their pre-recession levels of productivity in the near future. This implies an increase in the structural deficit that will not be rectified directly through a return to growth.

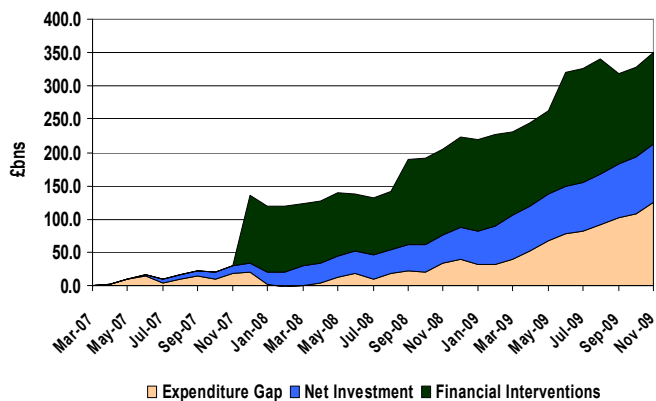
The government's plans to reduce the debt, to date, are unimpressive, as it is reluctant to reduce spending while the economy remains weak, with the prospects of doing so even less palatable given

Comparison of UK's debt situation to peers



Sources: HM Treasury, Office of National Statistics

Evolution of the Public Sector Net Debt



Sources: HM Treasury, Office of National Statistics

the upcoming general election. Whichever party wins the next election will have tough policy decisions to make, and a hung parliament will increase the risks that those choices will not be made.

Investors often assume that indebted governments will seek to 'inflate their way out of debt', but inflation that becomes persistent will be priced into the bond market. Governments then would have to pay more to raise more debt, so this method is not very successful and is also dangerous. Inflation can quickly get out of control, and the economic cost of reducing it can be very high. Expanding the economy and tax receipts is the preferred method; however, the outlook for economic growth is not favourable.

Consolidation is really the only option available to the UK, and the composition of that consolidation matters very much. Governments that attempt to consolidate by increasing taxes and cutting capital investment generally fail. Tax increases promote inefficient capital allocation (people leaving the workforce, for example) whereas reductions in investment reduce future growth potential. On the other hand, governments that reduce expenditure are more likely to succeed in a permanent debt reduction, and indeed enjoy higher growth rates subsequently, as the future tax burden and overall unit wage cost are reduced.

With the UK economy likely to produce below-trend growth over the next couple of years, our base case is for inflation and interest rates to be contained. Nonetheless, there are risks to consider. Input prices are the main inflationary stimulus in the very near term and, while it is feasible that strong emerging economies' growth stimulates commodity prices, we believe this is more likely to depress consumption in the UK. Over-estimation of excess productive capacity could be a more likely trigger for a rise in inflation.

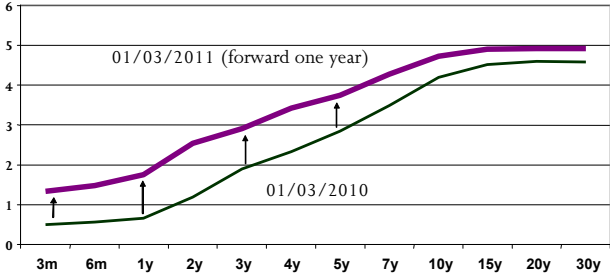
The downside risk for yields is clearly for interest rates to increase more rapidly than expected. Perversely, this could occur if the government loses control of the deficit. In these scenarios, we could envisage capital flight and a collapse of sterling, which would increase import prices substantially as well as have significant disruptive effects on the economy.

Assuming our central cases play out, we would not expect violent movements in sterling, although we acknowledge the risk that the currency weakens further if the government is unable to deliver a sensible consolidation schedule. In view of the devaluation already achieved, even a moderate improvement in the fiscal situation could cause a sterling rally.

We expect the gilt yield curve to flatten gradually, with the short end rising as interest rates are increased slowly.

The market also reflects this view, with forward contracts indicating that the gap between yields of very short-dated gilts and those with at least 10 years to maturity will be narrower in a year.

The market's yield expectations move higher



Source: Bloomberg

Key to the outlook will be the extent to which the market is able to accommodate government issuance. We believe banks will allocate more to gilts of a mixture of maturities, and insurance companies operating at the longer end (15+ years to maturity) will be encouraged to buy more.

Overall, we find the outlook for investment somewhat less than inspiring, particularly in the UK, because of expectations for subdued economic growth. US and Pacific (excluding Japan) equity markets appear in better shape and should provide diversification away from this potential weakness. This said, markets appear to have already started to discount much of the negative news in the UK, and we are keeping some powder dry to take advantage of opportunities as they arise.

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