MARKET INSIGHTS

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The impact of the CSR on UK financial assets

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The modest gains made by Gilts and UK equities on the afternoon of 20 October were in contrast to the large quantities of newsprint used to report on the key event of the day: the UK government's Comprehensive Spending Review (CSR). However, the CSR does appear to be fundamentally positive for UK financial assets.

The subdued market reaction to the announcement was because the headline number of GBP 81 billion of cuts in public spending, over five years, was broadly in line with earlier announcements.

This, along with previously announced tax increases, is intended to eliminate the GBP 109 billion structural deficit by the time of the next general election (due in 2015), using the government's GDP growth assumptions.

The CSR confirms that the government is determined to avoid the risk of a buyer's strike (like in Greece), should we face another bout of nervousness on bond markets over the very high levels of debt to GDP seen throughout the OECD. Another panic might have pushed up Gilt yields and bank lending rates and so have created a double-dip recession. The CSR also sends a political message to investors: that private sector activity is the preferred engine of economic growth, not government spending.

Some influential economists (such as the American Nobel Prize winner, Joseph Stiglitz) argue that the risk of a double-dip recession is actually higher now as a result of the spending cuts.

But if growth does begin to slow sharply as a result of higher taxes and cuts in public spending, the UK still has a vital weapon in hand that it would not have had if the Gilt market had succumbed to a prolonged sell-off, due to too much debt in the market. This is the ability of the Bank of England to engage in further quantitative easing (QE) and loose monetary policy, in order to limit the risk of a double-dip recession.

Economists at J.P. Morgan Securities do not anticipate a double-dip recession for the UK, rather 2.2% GDP growth in 2011 with CPI inflation of 2.1% by the end of next year (both on a year on year basis).

Gilts

"…we like Gilts relative to other major government bonds…"

Coupled with the likelihood of a further round of QE, starting either in November or February, and the Bank of England inflation forecast for CPI inflation of just 1.5% in two years time, our bond team is positive on Gilts and holds a slightly long duration bias. We may see the 10-year Gilt yield drop a further 20 bps or so (from today's 2.97%) over the coming months.

It is worth remembering that in May yields were briefly over 4%, and a few months earlier bond rating agencies had expressed nervousness over the UK maintaining its AAA rating.

On a global basis, we like Gilts relative to other major government bonds, particularly against German Bunds on account of tighter monetary policy coming from the ECB.

Sterling

Our currency strategists expect sterling to remain unchanged against the dollar in the medium term, with USD 1.55 to USD 1.60 considered fair value. The UK and the US are facing broadly similar macro-economic problems, with central banks in both countries about to resume printing cash in the hope of boosting credit and money supply growth. The ECB, with its current talk of tightening monetary policy, has contributed to a rally in the euro and we believe that the European single currency may appreciate to perhaps GBP 0.95 over the next 12 months.

Equities

"Investors have already priced in the CSR and tax hikes…"

UK equities appeared good value before the announcement of the CSR, based on relatively low price earnings ratios and also relative to Gilts on the dividend/yield gap measure. The likelihood of further QE is an additional support. We expect to see a rise in M&A activity as corporates take advantage of attractive valuations.

Investors had already priced in the CSR and tax hikes, and the fact that the fiscal tightening programme is in line with expectations is reassuring to investors. There appears little downside risk to the UK domestic-focused stocks, unless the UK does enter another recession that the Bank of England proves powerless to prevent.

Large and mid-cap exporters will benefit if sterling weakens against the euro. Meanwhile, the commodities that are used in manufacturing are largely priced in dollars and so should remain broadly stable.

From an income perspective, investors might prefer UK equities over Gilts, particularly given that many quality blue chip stocks offer dividend yields well above the 10-year Gilt, with some offering a dividend cover of more than two times. (However, investing only in the UK stock market for income increases the risk of single stock concentration, so investors may prefer a regional or a global equity solution).

Summary

The CSR was largely priced into UK financial markets. It does bring with it the risk of a double-dip recession, and the government is perhaps relying too much on the ability of further QE to offset the effect of tighter fiscal policy.

However, the government has achieved a credibility boost by delivering the cuts that it said that it would. The CSR has also highlighted the government's philosophy of preferring economic growth to come from the private sector rather than from government spending. This is a fundamentally positive message for the UK financial markets.