



This weekly Briefing Note aims to pick out some of the key financial and economic issues touched on in the press over recent days, and from time to time includes the views of some of our independent fund managers.

Scepticism remains

A growing scepticism over policymakers' responses to the economic downturn, coupled with continued negativity within the financial sector, weighed heavily on markets last week, with all of the major equity indices finishing the week down. After announcing the biggest quarterly loss in US corporate history, the struggling insurer AIG had to once again go cap in hand to the US taxpayer for a further bailout and the UK insurer Aviva saw its share price fall sharply as it announced worse than expected losses for 2008. The FTSE 100 finished the week down 7.8%, its fourth successive weekly decline. Wolseley fell sharply following its announcement of plans to raise £1bn through a rights issue and share placing. General weakness within financial stocks pushed the S&P 500 to a twelve year low, down 7.3% on the week, as General Motors saw its share price fall, with the technology sector also coming under increased pressure. The FTSE Eurofirst index reached its lowest point in its short twelve year history, as the insurance and banking sectors came under further pressure. However, there was a little respite as oil and gas stocks outperformed the wider market. Japan fared little better with the benchmark index falling by 5.2% to close at a record 26 year low. In currency markets the dollar held up well for most of the week as the general weakness in equity markets reinforced its status as a safe haven, however this position weakened on Friday following the worse than expected US employment report.

Into the unknown

This coming week will see the Bank of England (BoE) take a step into uncharted waters as it moves a step closer to the first stage of its quantitative easing plan. **The Financial Times** reported that Paul Fisher, the Bank's newly appointed executive, has made it clear that the initial decision to expand the money supply by buying up £75bn in government bonds might just be one of the boldest initiatives in the central bank's history. Should it be necessary, the Bank is prepared to buy even more gilts to ensure that commercial banks will use the money they receive to once again begin lending to the private sector. Since the widely anticipated announcement was made last Thursday, yields on the benchmark 10 year gilt have fallen by 53 basis points to 3.07% - the biggest fall since the IRA bombed the Baltic Exchange in 1992. Central banks across the world will be keeping tabs on the scheme as they ponder their next steps, with the highly cautious European Central Bank considering the possibility of using alternative methods to interest rate cuts to stimulate demand and US Federal Reserve also considering taking the step of buying its own Treasuries.

The article however went on to report that quantitative easing is not without its risks, and whilst these first steps have reduced yields on government bonds, the real questions will be asked, and answered, over the coming weeks and months. With little scope left for further cuts in the base rate, the BoE is left with no other weapons at its disposal. The real question now has become not so much will it work, but how much extra money do we need to print in order to stimulate lending? Mr Fisher stressed that the bank has no intention of making the same mistake that Japan made between 2001 and 2006, during which the money in circulation was increased by 74%, however even this was not sufficient to stimulate demand and revive a languishing economy. In contrast, the BoE aims to deliver its stimulus in a much shorter period of time, with it being set to increase the monetary base by as much as 80% in the next three months.

The first big test will come on Wednesday when the BoE will launch the scheme by buying £2bn of government bonds, which is likely to drive capital prices higher, precisely because the Bank is committed to buying such a large amount in a short period of time. For this reason, the Bank has decided to maintain its "reverse auction", whereby investors are the sellers rather than the buyers, and has also agreed to buy a certain amount of gilts at what are called "non competitive prices". This will allow insurance companies, pension funds and fund managers to be offered fixed prices, rather than risking selling their securities too cheaply. If the auction is successful, there will be further bi-weekly auctions over the next 3 months, until the full £75bn has been released.

Cash is no longer king

Last week saw the Bank of England cut interest rates for the 6th consecutive month to take the official bank rate to an all-time low of 0.5%. **The Mail on Sunday** reported that tens of thousands of homeowners will enjoy interest-free mortgages from next month as those on Tracker mortgages have gradually seen their repayments fall over the last six months. However, borrowers who took out fixed rate deals as little as 18 months ago could be trapped on rates of as much as 6.5%. A third of new borrowers decide on a Tracker mortgage, compared with 16% percent just over two years ago, however the deals on offer are now far less attractive as banks strive to restore their profit margins. At this point 12 months ago a borrower could get a three year deal at 0.06% percent below the base rate, however even the best deals available now are significantly in excess of the base rate.

Whilst this may be good news for some, many savers are beginning to feel the pinch as they see the returns on their savings accounts slowly dwindle. **The Independent** pointed out that the average savings account now pays considerably less than 1%, and whilst astute savers could have been earning more than £200 a month gross on an investment of £50,000 as little as a year ago, they will struggle to get half of that now and may be forced to begin drawing down on capital. However, the article went on to point out that, despite the FTSE 100 index approaching its March 2003 low last week, this has pushed the dividends on equities to increasingly attractive levels. **The Times** ran a similar article which listed alternatives to deposits in order of risk. Gilts were offered as the first alternative, however the deepening financial crisis has led to increased demand within the sector and current yields are at record lows. Corporate Bonds, debt issued by companies looking to raise capital, were listed as the second alternative, and went on to highlight the Invesco Perpetual Corporate Bond fund, managed by Paul Read and Paul Causer, who also manage the St. James's Place Corporate Bond funds, as a way of diversifying risk. Fears that companies will be unable to meet their interest payments has sent yields soaring, however many feel that these fears are overblown and that there are attractive opportunities out there, especially among investment grade debt. The third option was to invest into income-paying shares. The income yield, the percentage of a company's share price paid out as dividends over the year, is becoming increasingly attractive for many investors. The paper went on to say that investors should stick to companies that have strong balance sheets, such as Vodafone, BP, Royal Dutch Shell and AstraZeneca, all of which are yielding more than 5%. **The Times** also pointed out that for most investors the easiest way to get access is through equity income funds, and investors should consider a spread of risk, including exposure to corporate bonds as well as equities.

The Independent ran an article on how the last month has seen vast amounts withdrawn from banks and building societies, as investors go in search of more competitive returns. Many have been looking at the more exotic asset classes, however one sector seeing significant inflows is Corporate Bonds. As institutions have been forced to issue bonds to raise capital, this flooding of the market has seen yields on investment grade debt increase to between 5 and 7 percent. Whilst most commentators accept that defaults (companies failing to pay the interest on capital at maturity) will increase, the bond market is currently reflecting assumed default levels greater than the Great Depression and to many this is exaggerating the risk. A well managed portfolio is an obvious way to diversify the risk as well as offer a more attractive return than cash for those willing to take on a little more risk.

A good time to plan for the future?

The Times ran an article on why now could be a good time to consider making plans to save on Inheritance Tax. Since both property and equity markets have fallen over the last year and a half, almost £1bn has been wiped of the value of people's estates, however despite this the nil rate threshold is set to increase to £325,000 on the 6 April this year. The article explained that each year taxpayers waste as much as £190m on unnecessary Inheritance Tax payments, however the current climate presents the ideal opportunity for those looking to avoid the hefty 40% tax on their estates. Whilst there is no guarantee that asset prices will increase, it now appears to be an ideal time to consider making plans. Whilst many may have seen the value of their estates fall, this could mean that they can make plans to gift a considerably larger part of their estate which could result in a further saving.