



The Budget 2009

23 April 2009

Dear Clients

Yesterday saw Mr Darling deliver what by common consent was the most important Budget speech in a generation. We offer in this note our initial reactions to the announcements made by the Chancellor.

It is important to remember that apart from a few exceptions the measures announced in Mr Darling's speech do not become legislation until the Finance Bill receives Royal Assent. This usually happens in the middle of the summer. Between now and then there will be some lively parliamentary debate which may or may not cause significant amendments to be made to the Bill.

I expect that like me both your real and virtual letterboxes are already filling up with bulletins running through the detail of the measures announced so we will not repeat that here.

The **main measures** for private clients are:

- Top income tax rate increased to 50% from 2010,
- Highest rate also applies to many trusts,
- ISA limit increased to £10,200 per annum,
- Pension tax relief restricted for those earning (or who have earned) over £150,000 pa.

The **most important announcement** was that the projected annual Budget deficit is now £175bn.

Conclusions

The level of government debt we are suffering is unprecedented in the UK. At some point gilt yields are likely to rise which will be bad for existing conventional gilts. The market believes that the security of gilts has declined. Recently prices indicate that lending money to some companies carries a lower risk of default than lending money to the Treasury.

The tax rises that have drawn substantial press comment divert attention from the huge debt that we now have to repay. In order to repay this debt we will need at least some of a) rising inflation b) public sector expenditure cuts and c) increased taxation. We believe b) and c) are certainties and a) is more likely than not.

Actions

- Review conventional gilt holdings.
- Use extra ISA allowance when available.
- Review trust investments.
- Review the balance between expected income and capital growth within your portfolio.

Aylesbury

2a Alton House Office Park
Gatehouse Way
Aylesbury
Bucks
HP19 8YF
T 01296 484831
F 01296 437157

Hemel Hempstead

Charter Court
Midland Road
Hemel Hempstead
Herts
HP2 5GE
T 01442 269341
F 01442 219517

London

10 Dover Street
London
W1S 4LQ
T 0207 4933166
F 0207 4936202

Watford

64 Clarendon Road
Watford
Herts
WD17 1DA
T 01923 232938
F 01923 817159

www.hillierhopkins.co.uk
info@hhllp.co.uk

Commentary

Investments

Despite or perhaps because of the fantastically dull delivery, Mr Darling almost pulled off a clever trick yesterday. Many of the papers that I have seen so far have focused on 50% income tax for those on incomes of over £150,000 per annum. This conveniently diverts attention from a budget deficit of £175bn that is absolutely jaw dropping. Twelve months ago Mr Darling estimated “just” £38bn. When Dennis Healey went to the IMF in 1976 he borrowed £2.3bn. He was running a budget deficit of about 6% of GDP. £175bn is about 12%.

The anticipated increase in tax revenues from taxing the wealthy is £2billion. In the context of a £175bn deficit £2bn is close to completely immaterial. Even the £2billion figure may be optimistic for two reasons:

1. The individuals affected may decide to spend less on consumption than they have historically because of their reduced net income. This will reduce other tax income such as VAT, and cause other knock on effects that will reduce total tax revenues.
2. The specialist aggressive tax planning firms must see a great opportunity here – high earners used to paying tax at about 40% on income are likely to suffer a marginal rate of 50%, and the capital gains tax rate remains at 18%. Tax avoidance schemes will abound.

Clients may be wondering how this budget deficit will affect their investments. I think the quick answer is that the UK government will have to borrow £220bn this year in total through further issues of gilts (and treasury bills and other loan notes), and that to make these attractive the yield will eventually have to rise. This is bad news for existing conventional gilts, unless the outcome is a long term Japanese type recession in which case conventional gilts will be the only asset to own.

There is a strong consensus view that the growth assumptions in Mr Darling's projections are optimistic. If we fail to hit the high consistent growth rates Mr Darling predicts then, other things being equal, gilt yields will have to rise at some point and stay higher for longer than originally hoped. If the UK does produce some reassuring growth figures the Chancellor will come under pressure to tighten monetary policy. However, we know from Japan's experience that this can quickly put the country back into recession. So we must hope (and we can reasonably expect) that Mr Darling or his replacement will not be tempted to turn off quantitative easing too quickly. This is the conundrum of the quantitative easing policy – eventually the government will need to borrow money and will increase yields and interest rates will rise but interest rates have to stay low for the time being so that they do not choke off any recovery.

Equity markets are sensitive to all manner of influences but fundamentally equity markets try to value a flow of income or profit or cash. The ability of companies to generate and increase these flows is not helped by the worst recession for a generation. But that does not mean equity investment should be written off. Equity markets have endured bad recessions before. Historically equity market recoveries have arrived in fits and starts.

You will know that we do not think it is possible to time investments in the stock market in any conventional sense. We believe that for investment purposes most of the information is in the price. Prices reflect all known information about a stock. But those prices can sometimes be interesting.

The budget may not affect the equity market greatly unless the Chancellor's actions somehow significantly alter the fortunes of the companies concerned, or materially add to uncertainty.

In fact there is a perception that the Chancellor has been dealt a hand that is difficult to play and that for the time being there is little that he can do to alter outcomes significantly. If anything he must concentrate on trying not to make things worse rather than trying to make things better. This is a change from what we have become used to – dividing up the spoils of the Goldilocks boom economy has been replaced with dividing up less than nothing.

It is possible to insure against most things. We have for years used gilt and treasury bills as the base line – the risk free rate of return. The assumption is that loans to the government are super safe. But it is possible to insure against the possibility of the gilt or bill not being repaid. These insurance premiums have moved around a lot recently and perhaps the market is not perfect. But the cost of insuring 5 year UK government debt was 0.95% a couple of days ago. On the same day British American Tobacco, Centrica, Unilever and others all had a lower premium for insuring a similar debt. As Gillian Tett at the FT points out Cadbury had a cost of 0.50% to insure against their corporate debt failing to repay. This means that the market on that day thought that the credit risk attaching to the UK Treasury (who print paper money) was greater than that attaching to a firm that makes chocolate coins.

This suggests two things to me. We should be very worried about this country's indebtedness – the numbers are huge and every now and then the capital markets start to wonder whether the treasury will actually pay back its sovereign debt. But also Cadburys is in some sense as good a proposition to “back” as the UK government. I would generally rather own equity in a company than lend it money, but in this case either looks more attractive than conventional gilts (unless the investor needs protection from a prolonged recession / depression).

Sovereign debt default is not at all unprecedented. If you would like more information on this do drop me a line.

Tax savings

The ISA allowance has been increased to £10,200. Since most of our wealth management clients are aged over 50, the increased allowance will be available from 6 October this year (I notice that the only two tax alterations made almost immediately available were increases in taxation on alcohol and tobacco). The strong likelihood remains that as well as public sector cuts, taxes will continue to rise in the future. The burden will tend to fall on the wealthier sections of society. This makes ISA investing relatively more attractive than perhaps it used to be. Never let the tax tail wag the investment dog but if investments can be rearranged so that more sit within an ISA this is almost certainly a good thing. Do not forget that in the short term the actual tax savings are tiny. Another benefit is that ISAs do not have to be mentioned on your tax return.

The aggressive tax planners will launch many schemes in the coming months. I predict a particular flurry of low risk Venture Capital Trust (VCT) launches. A low risk VCT is a bald hairy man – a contradiction in terms. VCTs (and Enterprise Investment Schemes (EIS)) offer valuable tax breaks but these tax breaks are available because the range of possible outcomes, from very good to very bad, is generally wider than from investment in better established lower risk investments.

Trusts

Trusts will need particular attention. Standard discretionary trusts will be liable to tax at 50%. There are however worthwhile tactics to reduce this burden. Consider paying income out to beneficiaries, calculate whether the absolute amount is in fact a material number, consider holding assets via an offshore insurance bond, which can very often defer taxation liabilities, and consider alterations to investment strategies to produce capital growth rather than income.

Pensions

The proposed changes to the tax rules regarding pensions are most unpleasant for those still funding their pension schemes. The bulk of our wealth management clients do not make significant pension contributions so I will not cover in further depth here. We will be in touch with those of you that do or plan to make contributions in the coming tax year.

If there is any aspect of the 2009 Budget that you would like to discuss do not hesitate to contact your usual Hillier Hopkins contact or me.

Ben Sherwood
Principal

Ben.Sherwood@hhllp.co.uk

© Hillier Hopkins LLP April 2009

Hillier Hopkins LLP are registered to carry on audit work by the Institute of Chartered Accountants in England & Wales and authorized and regulated by the Financial Services Authority. The above commentary is intended for general guidance. It is essential that any readers seek independent advice before taking, or refraining from taking, action on any of the matters mentioned above. The authors and/or Hillier Hopkins LLP will not take any responsibility for the consequences of any action or inaction taken or not taken as a direct or indirect consequence of reading some or all of the above commentary.