New Minerva Report

Beware of Politicians

Gordon Brown's Budget was as "Old Labour" as any that previous Labour governments have ever produced. Make no mistake, this was a Tax and Spend Budget. Whilst many voters will agree with the good intentions behind the expenditure plans, they will also have an open mind as to whether the money will be spent in a manner that will produce the Health Service that we have all been led to believe is achievable. Once again this government is raising the expectations of the voters. They have promised on Education, Transport, Law & Order and Health.

The big money is going into Health. This is the one with the biggest bottomless hole. As medical science advances, so too will the demands on the Health Service. No matter what governments say, at the end of the day, there will have to be some form of rationing system. In the longer term, how the extra money is spent will have investment implications for everyone. Already many of the UK fund managers are buying shares in companies that will benefit from this money. In most cases, money spent by or for governmental departments is spent inefficiently. This will be good for many companies and, as usual, bad for us tax payers. It is quite probable that the NHS will not be able to cope with all the extra money.

The other side of the spending by the government of our money is where does it come from! It is coming from both the individual (consumer) and employers (capital expenditure). Now it could be argued that taxing consumers will slow their spending spree. The idea would then be that companies take up the slack. By taxing them as well, you could end up with much slower than expected economic growth. This is in fact the opposite of what Gordon Brown is predicting. Now we don't normally knock the government's economic forecasts, because they are usually better than most. But he has revised the longer term growth prospects upwards. Although this was by 0.25%, and equals that which the economy achieved in the last decade, it may be just the wrong time to adjust it. Growth for this year was predicted to be between 2 and 2.5%. The first quarter's GDP growth figure came in at 0.1%. So the economy has got a lot to do to get up to his forecasts. Next year he predicts growth between 3 and 3.5%. This will be when the tax, sorry NI, increases come into being. Companies are already looking at ways to cut costs to compensate for the extra tax burden that they will carry. What's worse is that this cost is directly proportionate to the number of people that a company employs. If companies start to lay people off to compensate, unemployment could start to rise. This means more expense for the government in Social Security costs. It means that consumers will draw in their horns. So, to reach their spending targets, the government will need to make more tax increases, or borrow more. That will hit the gilt market, which in turn will hamper shares.

Global Politics

One of the main reasons for the continued apprehension about share values is the rising perceived risk in global politics. It is not just the risks associated with terrorism and the fight against terrorism, although these are worrying enough. We discussed last month how the increase in the oil price, created by the Middle East friction, will act as a drag on economic growth. There are other worries as well. We hope that these are unfounded. However, the

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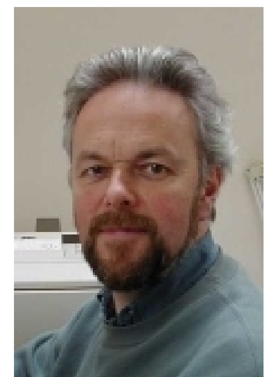
Paul Warner
Investment Director
& Editor of the
Minerva Report



imposition of steel tariffs announced by George Bush could backfire. The EU has announced plans to impose sanctions against companies in sectors as diverse as steel, fruit, rice, textiles, gaming equipment and fire arms. The list has been purposely drawn up to be politically sensitive. These are products exported from those US states which are crucial to George Bush if he wants to be re-elected. Whilst all this could be posturing by the EU, when the US is in a 'war' mentality, it will be hard for them to back down from their steel tariffs, which could in turn make it hard for the EU to back down. You may say, "so what?". But one of the reasons for the bull market of the 1980s and 1990s was the 'peace dividend', and with it the increased globalisation which boosted trade, which, in turn, boosted the world's economic growth. So keep an eye on these events. They have long term investment implications if they are not resolved amicably.

US Dollar

Does anyone remember Nigel Lawson? In the late 1980s, as Chancellor of the Exchequer, he said the current account deficit was nothing to worry about. As long as the government was in surplus all was well. The current account deficit merely demonstrated that the rest of the world wanted to invest into the UK. Soon after these assertions, everything fell apart. The pound fell, and interest rates were hiked from 7.5% to 15% in less than 18 months.

The US Dollar is the world's reserve currency. As such, it is arguable that it is not the same risk as the pound was then. However, Paul O'Neill, the US Treasury Secretary, is making similar comments about the US's Trade Deficit (current account) as Nigel did. A study by the Federal Reserve of large current account deficits in developed economies, showed that the deficits usually reversed when they got larger than 5% of GDP. On average this adjustment went hand in hand with a nominal exchange rate fall of 40%. and a sharp slowdown in GDP growth. Some economists are predicting the US's current account deficit will reach nearly 6% of GDP by the end of next year. If they are right, the US Dollar is an accident waiting to happen. The correction in the US dollar, which we have been predicting, may have already started. This is not good news for investment into the US market. It will be better to put money into markets that are closely correlated with the US market, to avoid losing out on the US dollar, unless you can hedge it. This is a longer term investment theme. and we will see if we can find any US funds that will hedge.

As Expected

The initial figures for US GDP growth show that the economy grew by 5.8% in the first quarter of this year. This was above consensus expectations and was, as we expected, fuelled by a rebuilding of inventories. One of the reasons for the market weakness over the past few weeks has been that investors are starting to ask the questions that we previously posed. That is, once the stock-building increase in economic growth has finished, where will the next impetus for growth come from? The answers that they are starting to come up with correspond with our view, that there will not be any great follow through. The consumer can not continue to borrow and spend. Companies are still too busy trying to cut costs, rather than working out how to spend money. This is actually good news for the corporate bond markets. If companies have no projects to spend money on, they will not come to the market to borrow money. However, those companies that are in trouble will be coming to the market to keep themselves going. You will thus end up with an increasingly polarised corporate bond market, between good companies and bad. The worst companies will default on their debt or swap debt for equity.

Small Cap Vs Big Cap

Prior to the last bull market, which started in 1982, all academic research showed that smaller companies would outperform their larger brethren. Like everything that becomes the accepted view, it all fell apart. Big-bang in 1986, the disappearance of the smaller stock broker, and the 1987 crash, saw liquidity and interest in smaller companies dry up. However, we think that the new investment era will re-introduce that outperformance. The reasons put forward for smaller companies doing better, is that they are more adaptable and manoeuvrable. Also it is easier to 'double your profits' from the hundreds of thousands than from a billion or more.