

## Budget Viewpoint

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**Viewpoint is our regular research bulletin for private investors. This review of the budget is written by our chief economist, Peter Bickley.**

### Mr Darling's last hurrah?

I don't envy Mr Darling. Getting the job when he did was about as poisonous as chalices get. So he gets some points from me for simply turning up rather than taking the much more alluring alternative of heading off in the ministerial limo to the remotest hills he could find. He gets some more for a rather refreshing honesty in some of the numbers though that doesn't do much to reinforce confidence in the forecasts. Please note a health warning: other commitments mean this brief commentary is being written immediately after the speech, with no opportunity to scour the fine print for all the usual flummery. Usually, believing what is said on the day is a pretty dodgy bet; if it turns out we've been duped, the next Viewpoint (mid-May) will pick up the pieces.

We are, without doubt, in a mess. It's true, of course, that most other folks are too and in our individual and collective ways we have each managed to make life more difficult for ourselves than it should have been. Here in the UK our self inflicted injury is well known; contrary to claims emanating from 'sources' close to Whitehall, we certainly did not fix the roof while the sun shone – rather we flogged off a load of the slates. No surprise that we have dry rot in the attic.

But what is done is done; for us now the important issues really revolve around how we get out of this hole and whether this budget helps, hinders or is even relevant. Note that third option; I was vaguely supportive of the general principles underlying the Pre-Budget Report ('PBR') last November ('keep on digging') if critical of much of the content. But so what, given that very little of it has actually been implemented as yet? It is very likely that this budget will also turn out to be a lot stronger on promise than delivery; you can, after all, spend £1 only once, although you can always print a few more...

The numbers have become so huge and so far removed from previous estimates that it is hard to keep a grip. Back in November we did wonder whether Mr Darling was deliberately flagging pessimistic numbers to buy some headroom; we'll never know but what is now clear is that November's numbers are eating dust. Most of us, though, are in the same boat on that front; the scale of the decay in the public finances has exceeded even the most aggressively sceptical forecasts.

In part that reflects the reality that the crunch in economic activity around the world in the aftermath of the Lehman collapse and continuing into the New Year was simply awesome. At the time of the PBR this was only beginning to be understood, although most independent economists had already inked in GDP forecasts that were several quanta more pessimistic than the Treasury's (which even at the time were simply not credible). The Treasury's new numbers for this year and next look very much more realistic although sadly they still cling to the belief that growth will return to the relatively rapid pre-crunch trend rate over the medium term. This is a triumph of hope over reality, or deductive maths over economics.



Indeed this is really where the problem lies. Near term we can all agree that the numbers are starting to look more reasonable – if net debt at 79% of GDP can ever be called ‘reasonable’ – and we can work at getting our heads around a gilt issuance target of £220bn, though the risk of indigestion is acute. But the whole house of cards depends on confidence; markets need to be confident that the UK’s finances will recover to something more normal and sustainable and that there are credible plans in place to make that happen. It’s just like banking, even on the Captain Mainwaring model: the system works only as long as there is absolute confidence that the bank will be there forever, erode that confidence and the whole thing collapses.

So forget the silly little details, the headline teasers and the impressive sounding (and vacuous) stuff about preserving jobs and so on. Forget the nasty and irrelevant fiddling with higher earners’ tax rates and allowances which I can confidently predict will raise nothing (more likely a net loss to the exchequer given the needless complexities it brings with it). Forget any of the twaddle about ‘fiscal rules’, other perhaps than to wonder how Mr Darling can mention them without collapsing in hysterical laughter. Instead, focus on the long term picture and ask yourself: ‘is this a picture that the bond and currency markets can believe?’ The worry is that it isn’t.

Public sector net borrowing peaks at £175bn this year but by 2012 is miraculously melting away. Net debt is less tractable, rising to that 79% of GDP number by 2013, and falling materially from 2016. By that time the current budget deficit (remember, when we had ‘rules’ this was meant to be in balance ‘over the cycle’) is supposed to halve. But this is all founded on growth forecasts that are frankly risible. OK I’ve already said I can live with -3.5% this year improving to +1.25% next (though I wouldn’t bet the ranch on it) but where on earth +3.5% for 2011 and after comes from is anyone’s guess. Deductive maths again?

This was a dreary speech because the poor chap had precious little to say, long on pettifoggery and sadly short on credibility. It was padded out to fill the time just as the forecasts were padded out to try to look less embarrassing. I know that some readers will sigh at this and say I am biased, that my criticisms are unwarranted. But before they do, I suggest a look at the immediate reactions in the markets. Faced with that £220bn to swallow the gilts market wilted; as the speech went on, the collapse in sterling accelerated. Currency markets are notoriously fickle but so far as international investors are concerned this budget got an immediate, emphatic thumbs-down.

So going back to the original question: help, hinder or irrelevant? Sorry, but this ongoing misallocation of capital, this misunderstanding of the perverse effects of ill-considered micro-managing, the disincentives inherent in capricious personal tax changes and the sheer lack of credibility make for only one answer. This budget’s only contribution to our salvation is another plummet in sterling, not a great claim to fame I’d say.



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Peter has been in the investment business since 1970. Initially working in private client stock broking he spent 12 years running a large private sector pension fund before joining Tilney in the pension fund team in 1991. In 1993 he became Head of Research. He is now our Chief Economist and is also a member of the Deutsche Bank Private Wealth Management Global Investment Committee, responsible for the direction of Deutsche Bank’s dynamic multi asset-class investment process. Peter is a popular writer in the media and is noted for being probably the only UK Investment Strategist to run an alpaca farm in his spare time.

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