

## Next week's Budget: VAT increase more effective than income tax tinkering, says F&C's Scott



The markets reacted negatively to last year's Pre-Budget report due to a perceived lack of commitment to curb the public sector borrowing. With an election looming in May, will Alistair Darling use what might be his last Budget to produce tangible, realistic changes to help the economy get back on its feet? F&C's Ted Scott, Director, UK Strategy, would like to see the Government have the courage to implement some measures to reduce the deficit without jeopardising the fragile recovery.

Scott commented: "The Government has a commitment to cut the deficit in half in 4 years; if it is to achieve this it cannot rely on a growing economy generating higher tax receipts alone. I think an initial increase in VAT by 1% should be imposed. This is not as high as the 20% some commentators have suggested but as the economy recovers further then it could be increased again at a later date to reduce the deficit further. I think that an indirect tax like VAT will be much more effective than increases in direct tax (e.g. taxing higher rate taxpayers at 50%) as it will produce much more revenue to the Treasury for a given percentage increase and is also harder to evade."

Although it will not be popular (no tax increase is), Scott anticipates that the electorate would accept such a move, and it should not be a vote loser, as long as it is communicated effectively. In fact, with the Tories prevaricating about what they are going to do, this could work in the Labour government's favour as it shows decisiveness over tackling the deep seated economic problems of the UK. In the US, Obama has retreated from his Big Government policy that appeared fiscally irresponsible and has now changed to a stance that recognises the structural problems of the fiscal deficit which is more

in tune with the electorate. However, it needed the loss of a key seat in Massachusetts for him to recognise this. Scott believes the disappointing recent inflation data is due to temporary factors (VAT re-imposition, fuel price rises etc.) that should quickly be reversed. However, the threat of a double dip recession is real and if VAT is raised the Government should do something that offsets the increased burden to consumption. Scott suggests that this could include incentives for the banks to lend to businesses and penalties for depositing liquid assets with the Bank of England, so encouraging them to lend more. Although QE has helped prevent a financial meltdown it has not resulted in increased lending by the banking sector and this was partly what it was designed for. Therefore, some measures to cajole the banks to increase credit lending could be necessary in the absence of it happening naturally. Scott also predicts that the Government may do something populist, particularly as the election is impending.

"Most obviously this would be some form of new banking regulations. Specifically, the announcement of the recent Volcker rule in the US provides an opportunity to announce something similar. I wrote a note late last year about the need for a new Glass-Steagall Act to be implemented to prevent a similar financial crisis in the future and something on these lines would, I think, be popular and well received by the media if not the banks themselves," Scott concluded.

### IPOs may fare better in small cap

Many industry experts predicted that increased IPO activity would feature prominently throughout 2010, with a backlog of companies waiting to float following the effective closure of this avenue over the last few years and whilst banks remain reticent to lend.

In line with expectations, IPO levels have indeed increased with some high profile companies – such as New Look and Travelport – trying to come to the market recently in an attempt to raise funds. However, many have had to withdraw once the market made it clear it was not prepared to pay the valuations being asked for what appeared to be an exercise in paying down debt in over-leveraged private equity situations.

Whilst it would seem that the market is not quite ready for IPOs at the larger end of the market, Catherine Stanley, F&C's

Director, UK Small-Cap, believes the story is very different at the smaller end of the market.

"There are some quite interesting companies at the small-cap and tail end of mid-cap – around £25m-£400m - which are looking to come to the market and are more likely to have successful flotations. These are largely companies which are not private equity-backed or over-leveraged, but rather have sensible balance sheets and cashflow. What also sets them apart from the high profile IPOs is that they are likely to have more realistic pricing expectations," Stanley commented.

One such example was the recent IPO from Digital Barriers, a £25m market cap new venture from the team behind Detica Group plc. Previously a supportive shareholder in Detica, Stanley seized the opportunity to invest in a start-up company from a quality management team with a proven track record.

Should the IPOs for these smaller companies be successful, Stanley believes that this could open the door for similar companies to come to the market and signal the return of healthier, more normal market conditions. Stanley concluded: "Whilst the headline news in the wider market place looks very negative for IPOs, that shouldn't detract from the fact that at the supposedly less glamorous small-cap end of the market, the IPO channel looks set to reopen."

### European Assets dividend up by a third

European Assets Trust, the specialist small and mid-cap Continental European investment company managed by Crispin Longden at F&C in Edinburgh, has declared an increase in its dividend payout for 2010 of 33% in euro terms to €0.432 per share (2009: €0.3248). This is in accordance with the Company's policy to pay out an annual dividend equivalent to 6% of year-end net asset value. During 2009, European Assets Trust's portfolio benefited from the recovery in the stock prices of continental European smaller and medium-sized companies. The Company's net asset value total return (capital performance with dividends added back) per share was +42% expressed in euros and +31% in sterling.