



Ted Scott on the wire

Ted Scott
Director, UK Strategy

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The Comprehensive Spending Review What does it mean for the economy and markets?

Summary

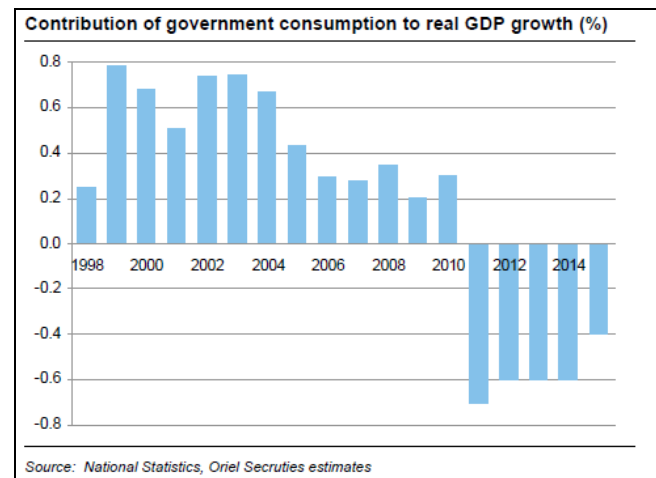
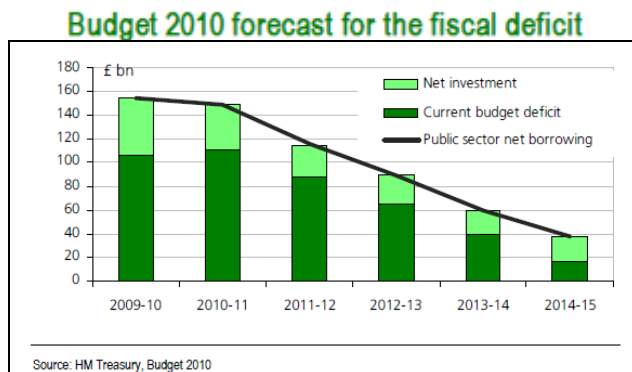
- **The scale of the problem**
- **Where the axe has fallen**
- **Implications for the economy**
- **Implications for the markets**

Background

The Comprehensive Spending Review (CSR) is the cornerstone of the government's austerity programme. The stated aim is to cut the public sector deficit from 10% of GDP to 2% by 2014/15 with the pace of the spending cuts to be spread evenly over the next five years. The size of the spending cuts amount to some £80bn and represent about 75% of the planned reduction in the deficit. The balance will come from tax increases that, in contrast to the spending cuts, are more front end loaded.

The point of the CSR is to detail where the various government departments will be affected by the cuts in spending. It focuses on the part of government expenditure that can be controlled (department expenditure) as opposed to spending managed by demand factors and prior commitments (annual managed expenditure), although there will also be savings here, especially in the areas of social security, tax credits and state pensions.

The size of the proposed cuts means that the CSR is the largest macro risk to the UK economy, and markets, for 2011. Based on the pace of the planned cuts to 2014/15 it is estimated that UK GDP growth will fall some 0.5% annually in each year to 2015 compared to a positive contribution of around 0.2% from government expenditure for the years 2006-10. This is illustrated in the bar chart below:



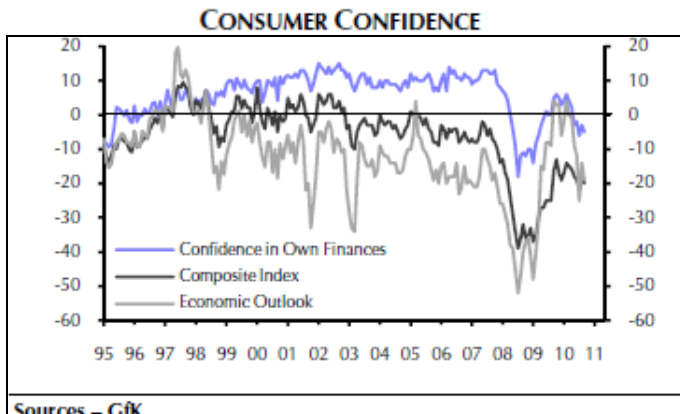
To be successful in achieving its aim of reducing the deficit by 8% over the next five years requires the deepest and most sustained fiscal consolidation since the end of the Second World War. We have known for a while about the size of the cuts and ministers have been preparing the ground since the coalition took office about how severe they will be and that everyone will be affected. In this respect, the government has been successful as the population and the media appear to have accepted the necessity of the CSR in contrast to France where there has been considerable public resistance to much less stringent reforms.

The revelation of where the cuts are going to fall is, therefore, important both for the future prospects of the economy and asset markets. Expectations ahead of the CSR have been managed well by the government but confidence has already taken a hit as the extent of the spending cuts and tax increases has become known. The following graph shows how consumer confidence has waned again after the recovery last year as we emerged from the recession.





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For the economy and markets, therefore, it is important that confidence is not undermined more by the breakdown of the spending cuts in the CSR, which is considered below. This is partly reflected in the announced distribution of cuts whereby some departments are more economically sensitive than others to a reduction in spending.

It is also important the CSR does not undermine the government's credibility. The new administration have engaged in tough talk about the need to reduce the deficit and if it was perceived that the Review was slowing down the pace or reducing the size of cuts it would harm the authority of the government and markets would take fright. Also, the credit rating agencies have publicly applauded the planned deficit reduction and the government would not want to undermine their confidence in the UK's public finances. For instance, cuts in infrastructure spend would have a greater effect than cuts in overseas defence.

The Spending Review

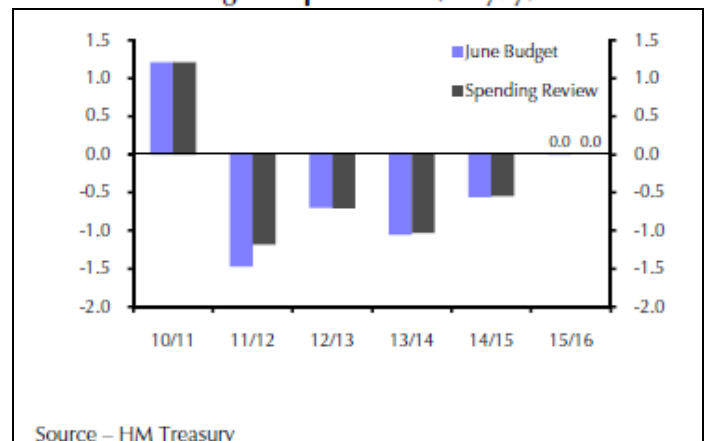
Contrary to some expectations the Chancellor remained true to his word and delivered on the promised spending restraint. There was no significant dilution of the fiscal consolidation and neither were the spending cuts re-profiled meaning the implementation of the cuts were not slowed down to allay the pain in the short term. Indeed, the cuts are broadly linear in their profile so the impact will be immediate.

The Review does include a modest increase in capital expenditure of £2bn per annum more than the Budget in June envisaged so that the total spending cuts fall back from £83bn to £81bn.

This is equivalent to about 6% of GDP. However, over the period there is an increase in spending from £637bn in 2010/11 to £693bn in 2014/15 although that represents a fall in the proportion of GDP from 43.2% to 38.4%.

The major change announced is that more of the cuts in spending will come from welfare and efficiency savings, rather than departmental spending. The government departments will see an average cut of around 19%, which is less than the 25-40% expected and partly represents the successful haggling by departmental ministers. The contrast to the cuts expected in the June budget is shown in the table below:

Real Total Managed Expenditure (% y/y)



Looking at the individual departments, the main winners were health, which had a protected status, and international development, both of which see rises in real spending over the course of the Parliament. Also, within education the schools budget is protected although the universities, as has been well publicised recently, lose out. The big losers are the Home Office and Department of Business, which suffer losses of 26% and 21% in spending respectively. The welfare budget, controversially, also has had swingeing cuts applied to it. In all, only four of the 24 departments will see an increase in spending and there is a summary in the table below:



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Real Total Spending Plans by Department

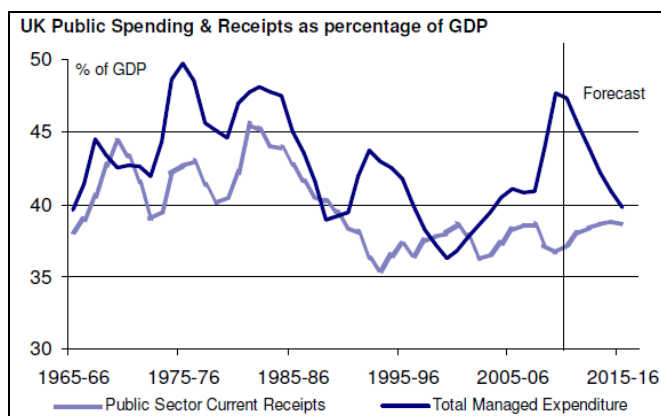
Department	% of DEL 10/11	Real Change in DEL (10/11-14/15, %)
Health	27	0.3
Education	15	-10.8
Defence	9	-7.5
Business, Innovation and Skills	5	-28.5
Home Office & Justice	5	-25.1
Transport	3	-14.6
Int. Development	2	34.2
Scotland, Wales & NI	14	-10.8
Other	19	-26.1
Total DEL	100	-11.2

Source – HM Treasury, DEL = Departmental Expenditure Limit

What will be the implications for the CSR for the economy and markets?

With little in the Review that is different from expectations, the main question remains whether the economy will be strong enough to withstand the proposed cuts and prevent a relapse into recession. The economy only came out of recession less than a year ago and is growing at a rate below that which is usual following a deep recession. This reflects the continuing deep indebtedness of the private sector allied to the reluctance of bank to extend credit and these problems will still take a long time to resolve. The austerity cuts will make it more difficult for individuals and companies (especially small companies) over the next four years and the Chancellor has delivered an Emergency Budget and CSR that leaves little room for manoeuvre.

The chart below shows the estimated direction of public spending and receipts over the next four years as well as the previous 45 years.



When the coalition came to power in May, it was imperative that the new government presented a credible plan to improve the country's public finances because there was a real risk that the credit rating agencies would lower the UK's AAA rating. If this happened it would increase the already onerous cost of borrowing and may have triggered a sterling crisis as investors lost confidence in the pound. The negative feedback has been graphically illustrated recently in Ireland and earlier this year in Greece where the loss of confidence has led to a soaring cost of borrowing as bond yields rise. After the outlay on the Department of Work and Pensions (i.e. social security spending), the interest on the government's debt is the next biggest commitment and, therefore, it was a top priority for the government to restore some confidence in the management of the government's finances.

The Review will satisfy the rating agencies as it has delivered what it promised at the time of the Emergency Budget in June. The gilt market's initial reaction was also one of approval as yields remained low with the benchmark 10 year gilt staying below 3%. In this respect, the reaction of the gilt market is more important than the equity market because if gilts fell sharply (i.e. the yield rose) equities would also retreat because of the implications for our sovereign debt and the prospects for the UK economy. Thus, while the gilt market remains relatively sanguine, equities should not add any further risk premium to the current modest valuation of the market.

Looking further ahead it is difficult to tell how the economy will be affected by the measures, especially as much of the detail is missing. It will be some time until we know how each department will best manage and spend its resources and whether the consumer will significantly tighten his/her belt in response to the cuts. The risk is that growth does gradually slow down causing unemployment to rise more than expected, which, in turn, will lead to lower government receipts and higher social security payments. If the economy does appear it is lapsing back into very low growth or recession it is likely gilts will retreat causing the vicious circle that Ireland has recently experienced. Early signs are positive in that the cuts have been well flagged and the economy has continued to grow at an accelerating rate despite the tax increases already implemented. However, it will be a big challenge over the next four years especially as the global growth environment remains fragile.

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