ARTORIUS WEALTH

UK BUDGET COMMENTARY

March 2016

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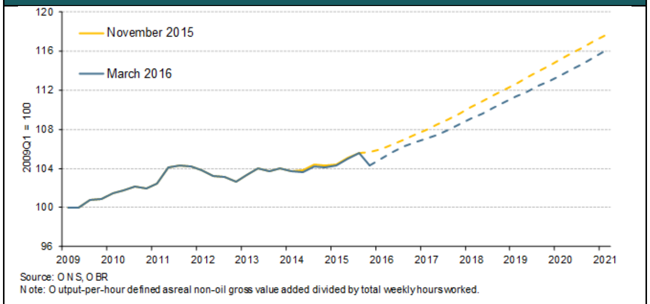
Sweet dreams?

After the sugar rush of an election win in 2015, the UK government has produced a Budget that highlights the difficulty of trying to please all the people all the time. Rather than concentrate on the headlines around sugar tax and Northern Powerhouse, both aspirationally correct in our view, we have looked at the economic forecasts and assumptions behind the Budget.

The 'independent' Office of Budget Responsibility (OBR) are led by well-regarded economists, but we would highlight that they remain optimistic in their expectations, and hence the economic foundations for the fiscal forecasts are shaky. We centre these on three areas:

- Projections of steeply rising productivity in the UK economy
- Expectations over increased levels of consumer indebtedness to drive the economy
- The forecast of fiscal tightening in 2019

UK economic productivity: output per hour worked, another revision down



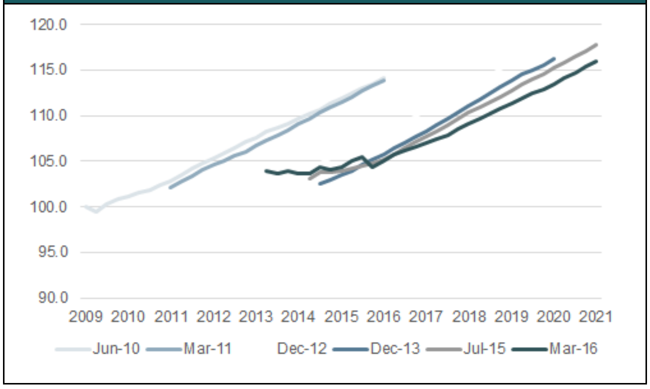
Source: Artorius Wealth, OBR

The assumption around productivity accounts for 85% of potential economic growth between 2015 and 2021. Since 2008 trend productivity growth has average 0.3% per annum and this is forecast to rise to 1.8% per annum for 2016-2020.

The OBR's track-record in forecasting productivity is not overly impressive. They have historically forecast productivity to improve, and each time it has failed to materialise. The lack of productivity growth is a contributory factor behind modest wage inflation despite robust employment growth.

The level of productivity is 7 percentage points lower than where it was forecast to be in 2012. The lack of productivity is a conundrum, but each successive OBR forecast and Budget is based on this conundrum resolving itself. Without higher productivity then the expectations and forecasts of much higher wage growth are likely to be missed, and with-it continued disappointment on tax revenue shortfall.

Previously flawed expectations for productivity



Source: Artorius Wealth, OBR

In defence of the OBR they highlight the lower productivity has stalked other economies, such as the US.

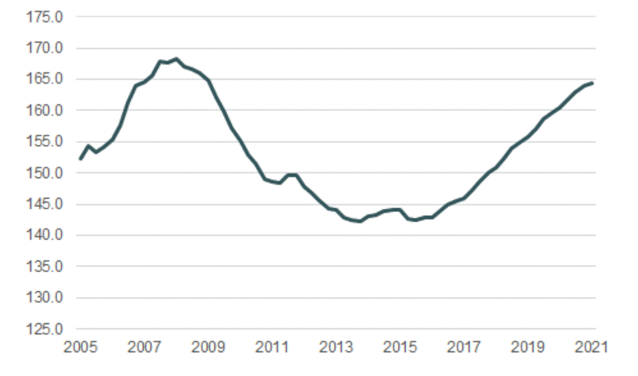
A challenge for governments is that the spending plans appear to be predicated on higher rates of tax revenue growth typically enjoyed in periods of stronger productivity. Without a return to higher productivity further fiscal adjustment will be required.

Relying on debt

The OBR continue to predict that the UK household sector will revert to type and borrow with alacrity. Having peaked at c170% of household income, debt ratios have fallen. The expectation, presumably dependent on productivity driven wage growth, is that households will increase their level of debt. The nature of debt accumulation is one often seen in periods rapidly rising housing market.

Key risk to a consumer debt boom is that wages may not rise, or the housing market may stall especially when faced with greater focus of curtailing risk lending by the Bank of England.

Household gross debt to income is forecasts to head towards peaks of old



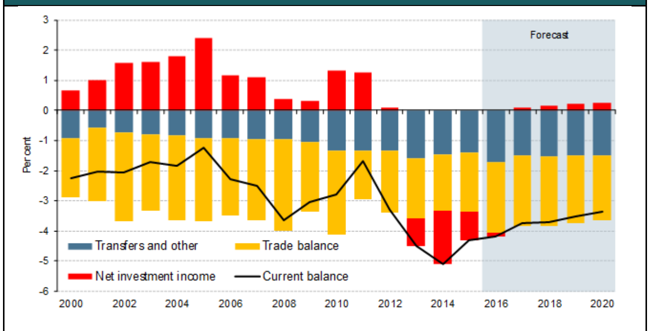
Source: Artorius Wealth, OBR

Twin deficits remain

The OBR continue to highlight the external risks that the UK economy continue to run, reflected in the scale of the Current Account deficit of around 4% of GDP. If the wage driven recovery of the UK consumer (aided by increased debt levels) does materialise then the current account deficit is likely to deepen.

Without a wage led consumer recovery then there is hope for a smaller current account deficit, although this would leave a large fiscal hole to fill.

Current account balance as a share of GDP



Source: Artorius Wealth, OBR

The risk of a prolonged period of external deficit is that the value of sterling will sharply fall as overseas investors lose confidence over the sustainability of the position.

Fiscally the UK's position has improved but Government net borrowing is amongst the highest of the major economies. The forecast of a budget surplus by 2020 reflects a significant fiscal tightening across the next five years.

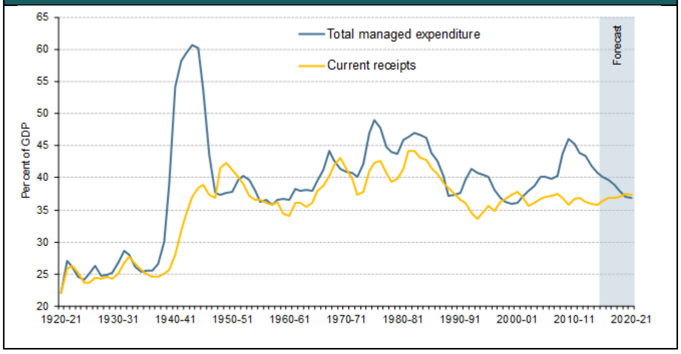
General government net borrowing as percent of GDP

	2015	2016	2020
UK (March EFO)	4.4	3.1	-0.4
UK (IMF)	4.2	2.8	-0.1
Germany	-0.5	-0.3	-1.0
France	3.8	3.4	0.7
Italy	2.7	2.0	0.2
Japan	5.9	4.5	4.1
U.S	3.8	3.6	4.2

Source: Artorius Wealth, OBR

The austerity is dependent on a prolonged period of government spending falling as a share of GDP.

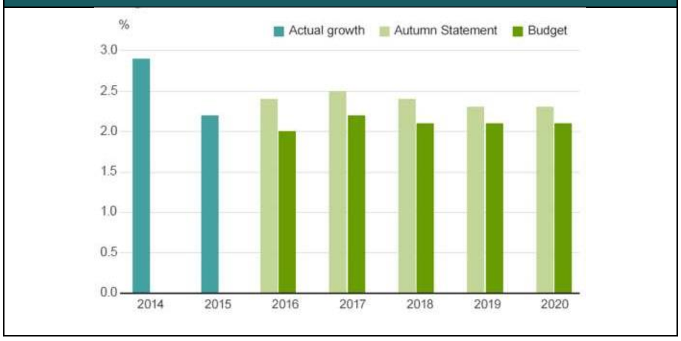
Total public sector spending and receipts



Source: Artorius Wealth, OBR

Growth expectations have been revised down, and given that these forecasts are predicated on robust productivity improvements and increased levels of consumer indebtedness, we suggest that the risk is for continued disappointment in the UK economy.

Growth expectation revised down for longer



Source: Artorius Wealth, OBR, Office of National Statistics

For investors we remain wary of UK, and continue to be negatively biased towards sterling where appropriate for clients.

Asset Allocation Views

Equities	(−)
US	(−)
UK	(=)
Europe ex UK	(=)
Japan	(=)
Pacific ex Japan	(=)
Emerging Markets	(=)

Fixed Income	(=)
Government	(=)
Investment Grade	(=)
High Yield	(=)
Emerging Market	(=)
Cash	(+)

Alternatives	(=)
UK Real Estate	(=)
Infrastructure	(=)
Private Equity	(=)

(+) = Positive view

(−) = Negative view

(=) = Neutral

Source: Artorius Wealth

Our Tactical Asset Allocation (TAA) tilts to the SAA to reflect our shorter-term cyclical views. Actual client portfolios will vary according to mandate, benchmark, risk profile and the availability of individual asset classes in different regions.

ASSET CLASS OVERVIEW

Equity	SAA	Commentary	TAA
US -3 **-2** -1 0 1 2 3	22%	We increased our negative stance on US equities from 'slight' to 'moderate' in early December. From a valuation perspective the US equity market appears fully valued and earnings revisions are weak. The risk of higher interest rates and tighter credit conditions, as seen in surveys, threaten the subdued economy.	-7%
UK -3 -2 -1 **0** 1 2 3	7%	We prefer mid-caps, implemented through exposure to the FTSE 250 Index, as they avoid the dominance of the commodity related companies found in the FTSE 100 index.	-
Europe ex UK -3 -2 -1 **0** 1 2 3	7%	We are of the opinion that the ECB's commitment to its asset-purchase programme will remain intact and continue to support the region's recovery.	-
Japan -3 -2 -1 **0** 1 2 3	0%	Following the Yen's depreciation, the earnings growth of Japan has been robust but challenges remain longer term such as demographics.	-
Pacific ex Japan -3 -2 -1 **0** 1 2 3	5%	With economic challenges emerging in developed economies Asian and emerging market economies and their equity markets have already slowed and fallen respectively.	-
Emerging Markets -3 -2 -1 **0** 1 2 3	5%	The outlook is mixed as valuations are lower than in developed markets but the weakening momentum is a risk that we will look to manage in coming months	-
Global -3 -2 -1 **0** 1 2 3	3%	In contrast to our regional asset allocation we have a global equity theme of water. As the global population grows, water resources are stretched and companies in water industry should benefit from increased expenditure.	-

Fixed Income	SAA	Commentary	TAA
Cash -3 -2 -1 0 1 **2** 3	0%	We opt for cash in the face of unattractive opportunities, in other asset classes. Long term we look to deploy cash holdings in higher return generating assets, but in times of turbulence cash offers a safe haven.	+7%
Government -3 -2 -1 **0** 1 2 3	14%	We remain neutral on government bonds overall, as the inflation outlook appears subdued in the near-term. The prospect of further bond buying from the ECB is likely to keep bund yields low, which in turn should prevent yields in other markets rising too far too soon.	-
Investment Grade -3 -2 -1 **0** 1 2 3	9%	In the UK and Europe there has been a modest increase in credit spreads in 2016, but returns remain attractive in most scenarios relative to government bond markets.	-
High Yield -3 -2 -1 **0** 1 2 3	4%	High yield markets in the UK and Euro area are shielded to date from the US high yield bond market.	-
Emerging Market -3 -2 -1 **0** 1 2 3	3%	We believe that valuations are attractive and sufficient to outweigh the potential volatility caused by the Fed's rate rises.	-

Alternatives	SAA	Commentary	TAA
UK Real Estate -3 -2 -1 **0** 1 2 3	10%	Yields and rental growth of 3% should also make a useful contribution to robust total return in 2016. Valuations appear stretched in absolute terms limiting long-term returns.	-
Infrastructure -3 -2 -1 **0** 1 2 3	5%	Valuations remain full, with limited scope for disappointment, but cash flow generation is drawing fund flows.	-
Private Equity -3 -2 -1 **0** 1 2 3	6%	The asset class most correlated to the economy, in terms of risk. PE houses are expected to deliver positive returns until the economy slows markedly or credit costs rise to curtail private market activity.	-

Source: Artorius Wealth

Key: The numbers reflect a quantitative description of our tactical positions relative to the strategic benchmarks. Our Strategic Asset Allocation (SAA) solutions offer a blend of assets that over a medium terms (5-7 years) will, in our view, provided the optimal mix of returns and risk at a given level of risk tolerance. Our Tactical Asset Allocation (TAA) tilts to the SAA reflect our shorter-term cyclical views. The SAA and TAA positions reflect a medium risk sterling on-shore based client portfolio. Views are subject to change and implementation in portfolios will reflect specific client requirements.

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