

Market Outlook

THE VIEW FROM ENDLESS

As the General Election draws near Endless Director Nick Leitch looks at what the future holds for a UK economy still suffering from the hangover of recession and sluggish growth - the price we are paying for the borrowing fuelled party that ended with a bang in the Summer of 2008

By the time you read this, Britain will be about to go to the polls to vote in a General Election which many pollsters predict will be the closest result for a generation. As Britain emerges somewhat reluctantly from the worst recession in seventy years, it is inevitable that the election battleground will be dominated by the economy. How bad a state are we all in? What level of recovery can we expect and what factors could impact on that recovery? Let us have a look at the evidence.

Its looks pretty tough out there....

It does not take me to tell you that Gordon Brown made much political capital from claiming to end the cycle of boom and bust in the elections of 2001 and 2005. He has been rather more silent on his record this time around. Perhaps the fact that the country entered into the deepest and most prolonged recession in living memory has something to do with his reticence, with the economy contracting by more than 6% in 18 months. Added to that, the government has created a borrowing deficit of eye watering proportions: £167 billion in 2009/2010 alone.

Britain is undoubtedly on the naughty boys list, as its economic reputation has taken a battering. Sterling has lost over a quarter of its value and some economists are boldly claiming that we are as bad, if not worse, than our southern European neighbours who are in need of financial bailouts from stronger European partners.

The truth is we were all guilty of allowing the growth experienced after the recession of the early 1990s to develop into a deep rooted dependence on debt. As the economy continued to grow it was reliant on consumer and public spending. As a result British households remain more in debt than any other of its G7 counterparts.

Furthermore, the current recovery is being supported by record low interest rates and over £200 billion pumped into the economy by the Bank of England in the guise of quantitative easing. At some point, albeit perhaps not until the last quarter of 2010 or into 2011, this emergency support will start to be turned off as interest rates begin to rise.

There also remains the factor of the Banks needing to restore their own capital base. We will see a continued restriction on the availability of credit which will act as a brake on investment and in turn on the recovery, particularly for SMEs



who often use this source as the first port of call when looking for investment finance.

There are fears therefore that the 0.3% growth recorded in the last quarter of 2009 will be wiped out by the constraining factors mentioned above, combined with slowing consumer spending driven by the increase in VAT back to 17.5%.

But it could be a whole lot worse....

The Conservatives, perhaps being buoyed on by Labour claiming that David Cameron wanted to take Britain back to the 1980's, responded by arguing that Labour were going to take us even further back to the 1970's with rising inflation, strikes breaking out, a weak pound and public finances all over the place.

Well, sorry Dave but we do not think it is quite that bad. Firstly, inflation has peaked at 3% - hardly the rampant rates of the 1970's, which were nearly 10 times higher. And comparing the strikes of BA cabin staff and some civil servants to those of the Winter of Discontent and the widespread wildcat strikes is frankly ludicrous.

Furthermore the fall in the value of Sterling should allow the economy to deliver a level of competitiveness that our European neighbours in Greece and Spain will not be able to benefit from, tied as they are to the Euro.



So where is Britain's recovery going to come from? For some reason, as a country we always seem to have a downer on the manufacturing sector but, whilst it would be churlish to suggest it is as sizeable as 25 years ago, it is actually in a far healthier state today. This is still a large component of the UK economy (at 12%, it is still 1.5 times larger than the financial sector) and we are the sixth largest manufacturing country in the world. After years of having to deal with the strong Sterling, this sector should now be mean and lean enough to compete successfully on the world stage.

But given the parlous state of the Banking sector's finances, it seems unlikely that investment in the UK's manufacturing sector will be able to fully fund the thirst for capital that may be required over the next two years for new plant and kit in order for this industry to take advantage of its market position. Perhaps private equity is best placed to fill this gap.

How should we feel?

So where does that leave us? A recent poll of Endless employees gave the British economic prospects a rather unimpressive 3.5 out of 10. Translated into something a bit more useful, this sounds like the anaemic growth rates which independent forecasters predict at 1.25% for this year and 2% for the year after.

Whilst the recession has not been painless (if in doubt just ask the former employees of Woolworths and Lehman Brothers) it certainly hasn't felt brutal. Both businesses and individuals alike have been shielded from the worst by the very low interest rates on their borrowing levels which have enabled many to navigate a course through the recession.

But this soft landing comes with a price. As the economy starts to recover, higher mortgage and interest payments will severely restrict consumer and business spending. This combined with the VAT increase and the proposed raise in national insurance contributions will have a perverse effect - the average Brit will actually feel poorer after the recession than during it. Don't expect a feel good recovery any time soon.

Government responsibility

With no real growth likely to come from higher levels of consumer spending in the UK, the ability of the manufacturing sector to deliver becomes all the more apparent. This will in part rely upon the next Government getting its own spending in order.

Long term investment in the UK can only be cultivated by creating a stable environment. Both main parties remain particularly reticent at the time of writing to explain exactly how and where public spending will be cut and taxes raised. Using terms such as "cutting waste" is not going to cut the mustard with investors or credit rating agencies, which are all waiting to see a detailed plan of what the incoming government will actually do to rein in the deficit. Without this perhaps their patience will run out.

If the incoming government can be seen to get hold of the country's finances this will at least lay out a route map for recovery and, in time, create confidence as well.

In conclusion.....

We are slowly emerging from what most of us hope is the worst recession we will ever have to deal with. Despite the depth and time it has taken us to come out, many UK businesses and individuals have surfaced remarkably unscathed. But in the short term this leaves us to face the dual challenge of weaning ourselves off the consumer debt addiction and surviving the shock of coming off the life support machine of lower interest rates.

In the medium term we must face the challenge of rebalancing the economy away from an over reliance on consumer spending; perhaps our manufacturing industry is best placed to start to achieve this. But the Government must not only repair its own finances but also create an environment that encourages investment and economic confidence. A tricky balancing act indeed.

What does Endless think are the key implications for individual businesses?

- **CURRENT TRADING.** Current trading is more predictable now than this time last year and as such management teams should be seeing an increase in forecasting accuracy. Although run rates are generally flat, proactive businesses should be implementing ambitious profit improvement initiatives in order to strengthen performance and increase cash generation ahead of sales growth.
- **BUSINESS DEVELOPMENT.** World class business development and marketing are key to survival as few if any sectors are expanding. Winning market share away from competitors should be today's primary focus.
- **CONTINGENCY PLANNING.** Good management practices require a regularly updated Plan B. Uncertainty requires preparation for the unexpected - e.g. a significant rise in interest rates.
- **WORKING CAPITAL FUNDING.** Investment in working capital will be critical in supporting future trading and growth. Management must prepare for this to be funded via equity given that in the current market the availability of external debt funding is limited and will only extend as far as security allows.
- **EXCHANGE RATE.** Lower sterling will help our exporters but uncertainty over future currency movements means that hedging strategies will become more important to protecting and enhancing margins in those businesses which are particularly sensitive to such fluctuations.
- **MANAGEMENT TEAM.** If management have not concentrated all of their efforts in anticipating market conditions and increasing the business' resilience, they might not be the right team to be leading the company out of recession.