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Osborne's Plan

George Osborne plans for spending cuts and tax increases of £40bn by 2014/15 but, added to Labour's earlier measures, these sum up to £113bn or £125bn by 2015/16. 77% of the deficit reduction is through cuts in spending and 23% from tax increases. Government expenditure will fall from 47% of GDP in 2009/10 to 41% by 2014/15 and borrowing from 11% of GDP to 2%. These forecasts are predicated on the independent Office for Budget Responsibility (OBR) expectations of growth accelerating to 2.75% p.a., employment climbing above 30m and inflation falling back to the Bank of England's target of 2% p.a.

There are many risks to this desired outcome. The early years see a much higher proportion of the deficit reductions being achieved by tax increases, particularly the 2.5% VAT increase from January 2011. This risks undermining the supposed private sector recovery. Equally alarming is the intention to persevere with Alistair Darling's proposed 60% reduction in state capital spending, equivalent to 1.5% of GDP. Given that public sector bodies will invariably attempt to squeeze spending on private sector contracts rather than cut jobs, the threat to a private sector recovery is very real.

The view appears to be that Nick Clegg was persuaded to accept the Budget proposals because Mervyn King (governor of the Bank of England) had successfully argued that increased credibility for the government (and sterling) would allow a much longer period of very low interest rates, thereby supporting recovery and facilitating the switch in economic activity between the public and private sectors.

Our feeling is that after a decade of significant relative inflation in public sector costs, this austere Budget does not allow for enough private sector inflation to enable the required deficit reduction. Only an actual reduction in public sector wages (which must have been deemed politically unacceptable) would have achieved this.

The early signs from the financial markets are mixed. Sterling had gained in value against the US\$ and Euro and yields on longer dated UK government bonds have fallen slightly. The measures appear to have achieved the required international credibility. Unfortunately, signals from the global economy in recent weeks are mildly negative. US growth in Q1 2010 was revised down marginally to just under 3% year on year and both housing and consumer spending post Q1 have been slightly below expectations. In Europe, most countries have reinforced deficit reduction plans including Germany, where, arguably, the country could afford to support growth in the rest of the EU. Poor growth in Europe is straining the banking industry which is also at risk from

default or devaluation on its substantial investment in Greek, Spanish, Portuguese and other sovereign debt. Fortunately, Chinese and the Asian economies still have momentum and any perceived threat from commodity prices to general inflation has eased.

Most of the taxation measures are positive from a business perspective. The reduction in corporation tax from 28% to 24% over four years is encouraging as is the £5m relief for 'entrepreneurial' capital gains at 18%. For an employee, at any level, the changes to income tax, national insurance, private pensions and VAT are wholly negative. The black economy and expenses culture must be the big winners. It may be that government is underestimating the private sector's ability to 'adjust' such that taxation fails to rise as anticipated even if the economy performs as hoped. This is particularly important in the UK where growth tends to be generated by very small enterprises.

For the stockmarket itself the main positive is the likely continuation of low interest rates and longer term bond yields as these increase the value of dividends from shares and reduce the discount rate for future growth. The major negative short term is the threat to profitability from the deficit plans themselves!

Plenty of profit growth is still 'baked in' from past cost reductions. Additionally, cost inflation is expected to slow through the absence of commodity inflation and sterling's likely new found stability. In these generally harsh conditions, the strong get stronger and inherent business weakness tends to be revealed.

For further information on Unicorn's philosophy, investment approach and performance or for more detail on the underlying holdings within the portfolios, please contact Client Services Manager, Myri Prior on 020 7253 0889 or by email myri.prior@unicornam.com who will be delighted to try and answer any queries you may have.

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