

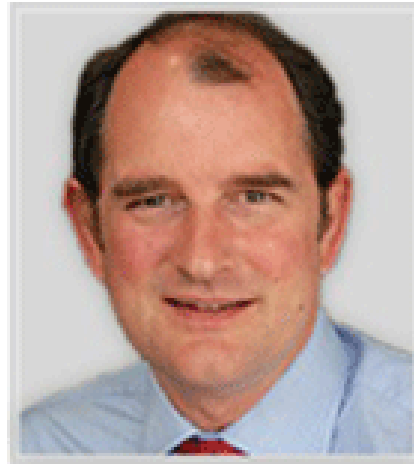
And now the hard work begins

By Tom Stevenson , 12 May 2010

Formation of Con-Lib coalition is just the beginning of a summer of difficult decisions.

The market reaction to the formation of Britain's first coalition government since the Second World War says it all. Cautious optimism is the watchword for investors as we enter uncharted waters. The FTSE 100 was broadly unchanged in early deals on Wednesday morning, while gilts and sterling held firm.

Details are thin on the ground but a few general observations can be made at this early stage. What the markets will be watching most closely is the new Cameron-Clegg government's approach to reducing Britain's £163bn budget deficit. Importantly agreement has not been too difficult to reach on this crucial front because the Lib Dems accept that spending cuts must do the heavy lifting in the necessary fiscal consolidation and they have been able to fall in with the Conservatives' desire to get on with the job.



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In light of the punishment meted out by the markets in Europe over the past few weeks, the reality is that they have little choice. However, this will remain the most challenging area in the weeks and months ahead because the gap between what needs to be done and what either party has laid out is still wide. The emergency budget, due within 50 days, will be a key indicator of the direction of travel but the markets will demand signs of decision well before that.

The UK is clearly not in the same boat as Greece and markets have been sensible to recognise this. Our overall debt burden is lower, we are better at raising taxes when required and we have good form when it comes to honouring our sovereign debt obligations. However, nothing should be taken for granted and a credible plan to put the public finances back on an even keel is essential.

On other key areas, compromises have already been made, not all of which look particularly good news for savers and investors. Capital Gains Tax looks to be at the forefront of revenue raising measures to fill the gap opened up by the Tories' acquiescing to the Lib Dems proposal to raise the income tax threshold to £10,000 over time. CGT always looked like an easy target given the discrepancy between the tax rate on earned income and capital gains so it is not surprising that it is first in the politicians' sights.

The move on CGT without the reintroduction of indexation relief represents a significant and new tax on growth in the capital value of assets due to general inflation and is all the more reason for investors to shelter as much of their savings as they can within tax-advantaged wrappers such as the ISA.

The raising of the inheritance tax threshold to £1m was starting to become an embarrassment for the Conservatives in an era of belt-tightening so they won't be too sad to park this despite its obvious popularity in

Tory heartlands. In return, the Lib Dems have agreed not to vote down a Conservative tax perk for middle and lower income married couples. A compromise has been reached on national insurance with a 1% rise for employees likely to go ahead while the employers' contribution will be halted.

Both parties campaigned for an abolition of the requirement for pensioners to annuitise their savings by the age of 75 so the prospect of an end to this iniquitous constraint must be in sight. Hopefully, any change to this rule will form part of a wider re-assessment of the incentives around pension savings – in particular a rethink of the previous government's ill-thought out proposals on the tapering of pension contribution tax relief.

A much fairer way of limiting the amount of Exchequer support to higher earners' pensions and reducing the overall cost to the Government would be an annual cap on pension contributions and the retention of tax relief at a saver's marginal rate.

The fundamental outlook for investment markets has not been massively altered by the tumultuous events in Whitehall this week. For FTSE 100 companies, around three quarters of earnings are made overseas so investors remain focused on the ongoing and sometimes opposing forces affecting the global economy.

Accelerating inflation in China threatens a monetary squeeze in the world's fastest-growing emerging market while the opposite problem continues to afflict Europe, where fiscal austerity threatens a return to recession. Despite this, corporate earnings continue to grow well and valuations are not stretched.

Closer to home, UK unemployment remains a concern, rising on the wider ILO measure to a 15-year high, and inflation hovers in the background as weaker sterling pushes up the price of imports. The housing market has stabilised, however, and interest rates look set to remain low as an offset to the inevitable fiscal tightening ahead.

The formation of a new Government removes some of the uncertainty that has dogged markets in recent weeks but there are still enough unanswered questions to keep investors on edge. In Europe, too, the creation of a €750bn backstop helps market liquidity but does nothing to address the solvency of countries like Greece where the political and public will to see through a period of grinding austerity is in doubt.

Against such a backdrop, the case for diversification has never been stronger. Exposure to a wide range of geographies and asset classes should go some way towards smoothing returns in the difficult days ahead.

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