

## Cash ISAs vulnerable to growing inflation

UNDER the new rules introduced on April 6 it is now possible to transfer existing cash ISAs into stocks and shares ISAs.

That has inevitably raised the question: Why can't existing stocks and shares ISAs be switched into cash ISAs?

The answer is that such a switch would require a change in the basic rules and would cost the government far more in tax reliefs because the annual maximum that can be placed in a shares ISA (now £7,200) is so much greater than the £3,600 that can be put into a cash ISA.

Cash is already more popular than stocks and shares ISAs and the government's view is that savers should be encouraged to diversify their assets and benefit from the potentially greater

long-term investment returns that equities can offer.

In normal circumstances that is a perfectly sound view, which we share, but while the present investment outlook is not normal, neither is the threat of higher inflation which can erode the purchasing value of cash savings very quickly.

So there can be sound reasons for wishing to take advantage of the new rule.

For instance, investors might find that their risk profile has changed and they are now ready to experiment with equities.

Others might have built up cash in an emergency fund for a specific reason that no longer applies.

INTEREST in emerging market sovereign bonds is growing as investors seek to diversify their portfolios into alternative asset classes in response to the credit crunch.

For those with memories of Mexico's Tequila crisis, the Asian currency crisis and Argentina's debt default in 2001 this will seem surprising.

But interest in sovereign bonds issued by those emerging market governments which have demonstrated their determination to achieve improvements in fundamentals – better management of their economies, greater liquidity, greater transparency and higher yields – has made their bonds popular, particularly with institutional investors looking for proven results over the longer term.

In the last nine years JP Morgan's emerging market bond index has risen by 183.47pc while the FTSE 100 index rose just 22pc.

Over the shorter term the

## Foreign bonds back in favour

comparison also favours the JPM EM bond index which rose by 4.7pc in the last year while the FTSE 100 fell by 5pc.

Elsewhere in this issue we report on the re-establishment this year of Brazil's fixed-interest foreign debt as "investment grade" which immediately sparked international investment interest in the Bovespa equity market as well as in the debt market.

Analysts of the foreign debt sector explain that quite a lot of emerging market countries have a lower default risk than countries closer to home.

One example is that of Romania which, said one, "wouldn't be allowed to get away with the current account deficit it has if it wasn't in the EU".

In the short term the current commodities boom, strong growth and cheap financing costs account for the success of the developing world's debt.

Funds specialising in the sector include Thames River's High Income fund, which provides exposure to corporate high-yield debt as well as "distressed" offerings, where the issuing company is approaching insolvency and provides a target for aggressive acquisition of securities superior to equity.

The Thames River fund is up 71.9pc in the last five years.

Other funds run by Pictet, ABN Amro and Templeton have also reported returns of more than 60pc in the last five years.

## Investor's Notebook

### WEALTHY WINDFALL

An unintended outcome of the chancellor's compensation package for ending the 10pc tax band will be a bonus for thousands of wealthy families. Among those receiving "double benefit" could be non-working spouses with five-figure savings accounts as well as asset-rich early retirees.

The 10pc band was always due to remain for up to £2,320 of savings interest for those with limited income from employment or pensions. Many of these will now also benefit from the chancellor's £600 increase in personal allowances for the under-65s. To benefit from the 10pc rate on savings individuals must have no more than £8,355 of non-savings income.

★★★★★

**HOUSE BUYERS** whose mortgage deals expire this year should start their search for a new rate now or risk a sharper increase in costs.

Mortgage rates are expected to rise further over the next six months irrespective of a further base rate cut.

Borrowers can secure a new mortgage rate up to six months before their existing deal runs out.

By the last week in May some lenders had already increased their rates by as much as 0.25pc.

Clients will appreciate that life assurance and pension plans are generally long-term investments and there may be penalties for terminating such plans prematurely; that past investment performance is no indication of future prospects and values can fluctuate; that in relation to house purchase their home is at risk if they do not keep up the payments on a mortgage or other loan secured on it. Some of the products and services mentioned in Money Planner might not be among those regulated by the Financial Services and Markets Act 2000.

The information in Money Planner is for guidance only and our expert advice should be obtained before any action based on it is taken.

## High street bonds

**THERE are still some equity market analysts who argue that the FTSE 100 index has been progressively overvalued ever since the low point of 3287 reached in March 2003 following the slide which started on December 31, 1999.**

**On a strictly objective view the present yield of about 3.7pc is low compared with traditional expectations for equities, especially in the absence of any equity risk premium, and clearly suggests that a correction is overdue.**

**It is now likely that the credit crunch, which started last August, will achieve much of that correction, over the next two years, mainly by removing the financing employed in the multifarious activities of leveraged buyouts, takeovers and hedge funds which have been largely responsible for the market surge over the last ten years.**

**Clearly, the next two years or so are not likely to be favourable for equity market growth and investors seeking a reliable income stream over the medium- to long-term should recall our recent favourable comments on the bond market.**

**Values of corporate bonds, including many issued by familiar high street names, have increased in sympathy with official bank rate reductions and we survey their potential in this issue.**

## Home loans

**DESPITE cuts in the official bank rate the cost of house mortgages is rising with higher lending rates and increased deposits.**

**We survey the situation in this issue.**

## Interest rate cuts postponed as Bank opts to fight inflation

**HOPES of a gradual reduction in interest rates over the next twelve months have been replaced by the possibility of increases following a warning by Mervyn King, governor of the Bank of England.**

At a stroke the governor has removed the embarrassing anomaly of encouraging expectations of lower interest rates, to avert an economic recession, long after the time when the need for higher rates to fight inflation had become irresistible.

The priority of fighting inflation will have the approval of most orthodox economists who traditionally fear the consequences of uncontrolled inflation far more than a slide into economic slowdown or even recession.

Ironically, although Mr King has had to contend with the "doves" on the Bank's Monetary Policy Committee (MPC) who have consistently voted for lower interest rates since August 2005, he has now been forced to concede that the economy will, in fact, move into slowdown for the next two years.

In August 2005 the MPC succeeded in

cutting the official rate by a narrow majority against the views of those who thought it should be raised and successive cuts reduced it from 5.75pc last July to 5pc on April 10 this year.

This should be seen in comparison with what is regarded as the most important rate in the economy: the three month Libor (the London inter bank offered rate) which is currently about 5.8pc – closer to the 5.75pc which was the official bank rate before the MPC started cutting.

Inflation can already be seen to present a potentially more intractable problem than similar threats in recent decades because it is not only home grown but is in the process of being aggravated by commodity prices from sources around the world and, in particular, through the price of oil.

For all of the present decade inflation in the UK and the western world has been kept low through the beneficial effect of cheap foreign imports, especially from China.

That phase is now being reversed by rising prices of produce not only in China but also in other emerging markets of India, Brazil and elsewhere.

Despite this negative factor, some of the emerging markets are beginning to attract international investment initially, as we explain in this issue, in the fixed-interest sovereign debt sector but also, in the case of Brazil, in the equity market.

## Life cover through a pension plan

A NEW scheme to allow employees to buy life insurance in a tax-efficient manner through their pensions is likely to attract members of small-self administered schemes (SSASs) and group self-invested pension plans (Sipps).

This will represent a partial restoration of the situation which applied briefly two years ago after the government had removed the previous 10pc restriction on the amount of life insurance allowed to be purchased through pension schemes.

The pre-Budget report of

December 2006 withdrew that concession so that no life insurance payments could be made through pension contributions.

The scheme now being made available offers trustees the opportunity to take out life insurance through a pension because, although *individuals* may not pay money into a pension life insurance plan, trustees can provide individual cover through a group life insurance policy and deduct the cost from the individual's pension scheme.

An attractive feature of the

new scheme is the opportunity it offers applicants under 50 to arrange up to £600,000 of cover without a medical examination.

It is expected that as employers move away from group money purchase pensions towards group Sipps the option of purchasing life insurance in this way will become more popular.

Employers will still need to provide life cover for their employees and in this way they can gain tax relief on it.

Please ask us for further details.

## In this issue

- Sipps enhancement
- Home loans
- Corporate bonds

- Brazil's upgrade
- Emerging markets
- Cash ISAs switch
- SSASs