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Econotes is a free research publication available on request. It is not a solicitation for business. It is devised and written by Dr. Andrew F. Freris based on 46 years of market experience which included senior positions with GT Capital, Salomon Brothers, Bank of America and BNP Paribas as well as senior academic posts with universities in London and Hong Kong

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THE UNITED (?) KINGDOM

Summary	Investment Conclusions
The main preoccupation of policy makers and policy observers in UK has been the timing of the increase in interest rates by the BoE. Not dissimilar to the Fed tapering discussion, but made more interesting, if that is the word, by the expectation games played by the BoE. Economic indicators are all healthy to strong, with the key worry focusing on the property sector and its rising prices. Adding political frisson is the Scottish referendum in September. The consensus is that the vote will be a “No”, but a close run decision will add to the Euro worries and could rock the markets. A “Yes” vote is hard to believe, and would be damaging to the markets, not least to Scotland.	There will be an interesting conflict between the clearly strong macros, way better than those of the EU and closely second to the US, and their impact on equities under the shadow of the impending rate hikes possibly yearend 2014. We prefer the GBP as an asset class till, at the least, the middle of next year when its actual or putative interest rate advantage will come under pressure from USD rates. Equities likely to stay unimpressive as are now, while property will come under the twin pressures of higher interest rates and punitive property taxes

Macro trends stay robust

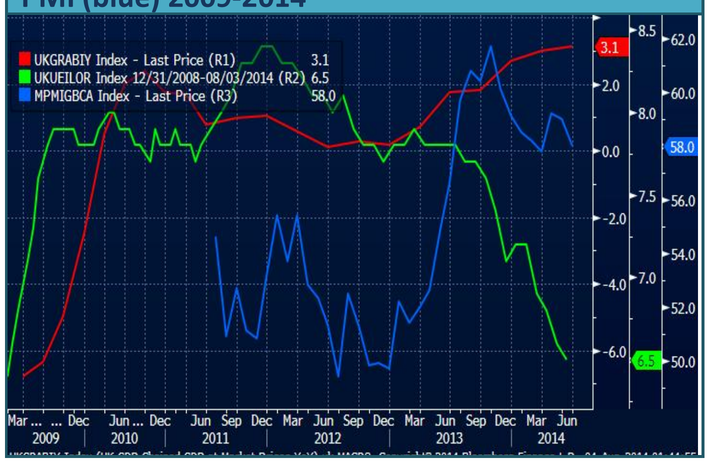
GDP growth in UK (red line in Chart 1) is now registering a strong pace with a string of impressive rates from 1.8 % to 3.1% yoy in the last four quarters. Growth has been supported by strong consumer spending, which, in its turn, was driven by falling unemployment (green line in Chart 1)

Business sentiment seems to have dipped at the start of 2014 but may have now bottomed and, in any case, it is above the 50 level on the PMI index (blue line in Chart 1)

Inflation has stayed quite benign despite the stronger performance of the economy and this has had a restraining influence on the BoE’s desire to see some normalization of the extremely low official rates.(See the red line in Chart 2)

Market expectations are clearly reflected in the slow but steady rise in the yields of the 2Y government bonds. What has caused a significant degree of anxiety, however, has been the rise in property prices (green line in Chart 2).There have been two issues here, the social aspect of younger buyers unable to afford the high prices, the latter driven in the more luxurious areas by almost exclusively foreign buyers. These varied from the ubiquitous Chinese all the way to Russian oligarchs and the older group of NRIs and Arabs.The other issue was a fear of a buble and its impact on the banking system, recovering from its near nationalisation afrer the 2008-9 crash.Adding to the uncertainty is the Scotish independence referedum in September. A Yes vote will not mean an instantly indepedent Scotland, but a long grind of negotiations on the decoupling of the two “countries” including questions of nationality, etc.

Chart 1:UK GDP (red) Unemployment(green), PMI (blue) 2009-2014



Source: Bloomberg

Property and bureaucracy gone slightly mad

A combination of efforts to widen the tax net as well as the political expediency of taxing expensive property owned by "foreigners", led to a spate of sharp increases on luxury properties taxes in the UK. First of all properties owned by companies and offshore companies in particular were taxed by annual flat rates depending on the estimated valuation of the property. Then capital gains tax, normally exempting a single property used as main residency, will be extended to all properties above a certain value. Mercifully the valuation date was brought forward to 2016.The tax was also was extended to non-resident owners who, until recently, enjoyed a relatively relaxed regime and definition of tax non-residency. Then the rules on defining non-residency for tax purposes were changed by the introduction of rules nearly surreal in their complexity and difficulty to interpret. The rules now include minutely calibrated periods of stay in the UK, plus resident or non-resident children and they include stays in a UK airport on transit counting toward negative points on residency. Definition now includes the availability of houses of relatives for stays in the UK …etc etc. To add insult to injury, there is a proposal to introduce a "mansions" tax at a flat rate on all properties over a certain value. The tax could be introduced after the expected 2016 elections. Bottom line is to think and plan carefully if you are a non-resident considering buying property in the UK!

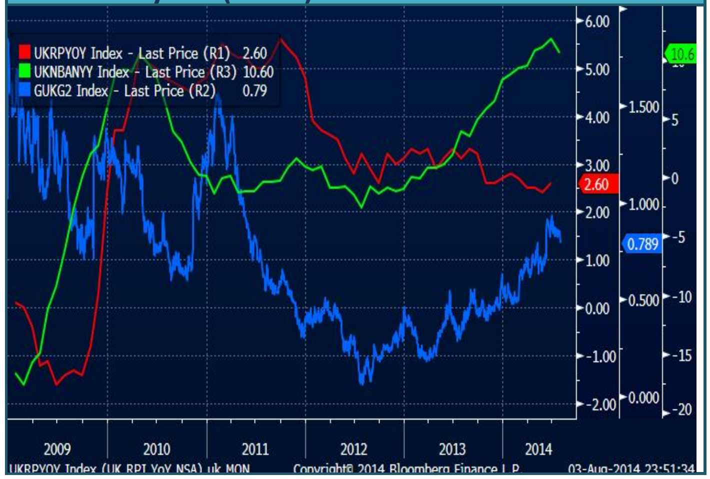
FACTOBOX: Nationalism is a risky game to play

So who is a Scotsman exactly? The present British Royal family is of 50% pure German ancestry as Queen Victoria, the great grandmother of it all, was married to Prince Albert, a German prince. The family was so aware of its Germanic origins that during WWI changed its surname and titles from, among others Gotha, to the more British Windsor.

Prince Philip, the great grandfather of the present family is Greek, having been born on the Greek island of Corfu. His mother spent her old age in a Greek nunnery.

Great Britain itself derives its name from Brittany the French province. Nothing clear in this world !

Chart 2: UK,RPI (red), Prperty prices (green),2Y Gvt bond yield (blue)



Source: Bloomberg

Investment implications

The stock market is one of the poorer performers among the developed countries of those with positive returns, The FT 100 is less than 1.0% up YTD. Valuations are not inspiring with 12M forward P/E at 13.6 and forward P/B at 1.8, compared to ,say, S&P which is 4.1% up YTD with nearly similar P/E at 15.3

As indicated, the expectations of higher policy rates as the economy improves will cast a shadow over the equities while keeping the GBP strong, staying over the 1.70 range into 2015. Property prices will be hit by taxes and higher interest rates while bond yields are bound to adjust, expectations- wise, the nearer the BoE gets to hiking.

The issue of the Scottish independence is far more serious.UK had in place for years now devolution of government with Scotland and N.Ireland having their own parliaments. What is new now is Scotland becoming an independent country and dissolving the union which made UK the United Kingdom. A vote of Yes will imply a lengthy and messy process of decoupling, as we said above, with a lot of thorny issues to be resolved, including that of citizenship/nationality, existence of borders (go through customs to go from London to Glasgow ?) as well NATO membership, let alone the issue of currency and membership of the EU. Our views of nationalism are hinted at in the Factbox!

(Writing completed 3/8/2014)