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Market Update – January 2006

UK Economy - This quarterly edition of the Market Updates report opens with a review of one of our previous predictions. In our January 2005 edition, we felt the FTSE 100 would struggle to pull away from its' level of 5000 points. It has not only done that but has achieved against our expectations by quite some way. Oil stocks account for nearly 20% of the FTSE 100 and therefore you could put much of the increase down to that, however performance in the 250, 350 and All Share have outperformed where there is less oil upside.

This reflects a significant disparity between the bullish trends in the secondary market and the dismal trends in business investment. Whilst this may seem puzzling it is not without explanation. Companies being cost sensitive and 'running lean' has made them attractive. The UK was never more physically healthy than when on rations, the same applies to the current corporate climate; ironically it is almost better off without the indulgences that financial security can afford. A smorgasbord of investment opportunities exists for investors (directly or via a managed vehicle) who may have tired, or tactfully retreated from, the property market. Conversely, that enthusiasm to invest cash is not replicated within the businesses themselves. Corporate investment decisions are driven by different factors and are subject to different risks, over different time periods, and therefore represent a more onerous level of commitment.

The critical point to this trend in the secondary market is that the market needs to settle at a level which reflects fair value for companies in this economic climate. Future growth in profits, and therefore dividends, are the unknown. Having stripped out cost to maintain bottom line and ensure some trading durability, there is a danger that this limits trading capacity for the future. Organic revenue growth remains threatened with exchange rate risk and trading partner fragility high on the agenda. M&A activity is supporting 'below par' organic growth. Acquisition pricing looks attractive when compared to the risk/reward of pursuing organic growth strategies.

One of our concerns raised in the July issue is coming home to roost for the treasury. Political focus has taken hold on the budgetary deficit and the risks associated with reduced future tax receipts. If/when Gordon gets the top job he may find that this haunts him for some time yet. The balancing of the Golden Rule and the servicing of public debt is devilishly difficult particularly when you are making assumptions on longer term trends. Growth has shown to be weaker than anticipated in the projections and therefore tax receipts will also lag; the 'house of cards' looks shaky. A little recognised fact is that the recent back down on the EU rebate will also have a significant impact. Whilst the concession on the EU rebate is only £1bn per year, that is effective for the full 7 years of the review term. That is £7bn that HM Treasury thought it had that now needs to be found elsewhere!!!!

