Chequer Financial Services

# CLIENT NEWSLETTER

# JULY 2017


Featuring:

INFLATION UP? Yes INTEREST RATES UP? Maybe

POLITICS, BUDGETS AND BILLS

THE £50BN EXODUS

THE END OF THE CHEAP STUDENT LOAN

CHINA COMES OF AGE

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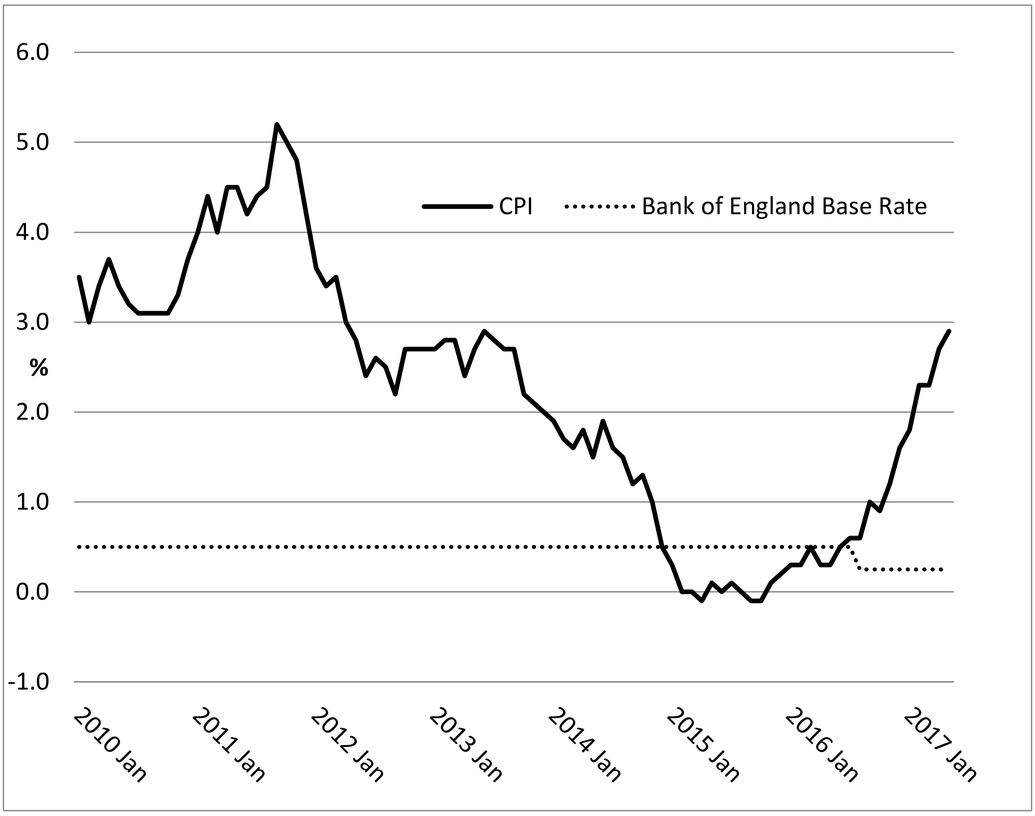
| INTEREST RATES UP? | MAYBE… |




The latest inflation figures came as a surprise for the markets and the Bank of England. Based on the government's favoured yardstick, the Consumer Prices Index (CPI), prices rose by 2.9% in the year to May, the highest level since June 2013. The Retail Prices Index (RPI), which is no longer an official statistic, recorded a 3.7% annual increase.

## The impact

The 2.9% figure was above the level which the Bank of England had expected inflation to peak in the fourth quarter of this year. It is also comfortably above the pace of earnings growth, which the most recent data showed to be running at 1.7% (excluding bonuses). That gap of over 1% implies a squeeze on consumers, who have traditionally been the mainstay of the economy. If you seem to have less to spend in recent times, now you know why.

## What happens next?

In the short term the experts, including the Bank of England, see inflation staying above the Treasury's 2% target. The question of how much higher it will go provokes differing opinions, depending largely upon forecasts of whether the pound will weaken further in response to

Brexit negotiations and UK political machinations. It will only take another 0.2% increase in the CPI for Mr Carney to have to write a formal letter to the Chancellor explaining why the Bank has missed its inflation target. He has probably already prepared a draft that refers to the fall in the pound from $1.50 just before the referendum to around $1.27 now.

In more "normal" times, the Bank would react to rising inflation by pushing up interest rates. However, as the graph above shows, we are a long way from normality. The last meeting of the Bank's rate-setting committee voted 5-3 to hold the base rate at 0.25%. The level of dissent subsequently prompted what looked like a public disagreement between Mark Carney and the Bank's chief economist, Andy Haldane, about when rates should rise. In practice, their differences were more nuanced, but the money markets are now pencilling in a rate increase for next year, rather than 2019. When it does arrive, that will be the first rate rise since 5 July 2007. Nobody is anticipating a rapid escalation once the increases begin. After over eight years of a sub-1% base rate there are concerns that borrowers of all kinds, from homeowners to the government, could not cope with a sharp jump in their interest costs.

### *ACTION*

*The rise in inflation means that you may need to review life cover and regular savings, including pension contributions, to make sure their buying power is maintained. On the investment front, the combination of rising inflation and miniscule interest rates means that holding a larger cash reserve than necessary is generally to be avoided.*

***After a period when inflation virtually disappeared, it is back with a vengeance. If your financial plans have not taken account of inflation, now is the time for a review.***

## POLITICS, BUDGETS AND BILLS

The Spring Budget, the last of its kind, was on 8 March 2017. After a rapid U-turn on increasing national insurance contributions for the self-employed, everything seemed to be on track until Theresa May decided to call a snap election. The consequences for Mr Hammond's first Budget are still being felt.

### 100% Finance Bill, 20% Finance Act

Mr Hammond's Budget première was followed by the largest Finance Bill ever, running to over 750 pages. The size of the Bill was not all his fault: some of the more complex measures had been set in train by his predecessor, George Osborne. Nevertheless, the sheer weight of the Bill served as a painful reminder that for all the talk of tax simplification, the reality is that tax becomes more complicated each year.
This time around the "complification" process hit an obstacle in the form of the snap election. As a general rule, it takes three to four months for the Finance Bill to wend its way through the parliamentary processes to the Royal Assent stage, when it becomes a Finance Act. The timing of the election ruled out such a protracted gestation period, as a Finance

Bill cannot be carried over between Parliaments. As a result, about 80% of the Finance Bill legislation was dropped and a Finance Act of about 150 pages was rushed through in a matter of days.

## The lost 80%

The 80% of the original Bill that was culled included two measures which had important consequences for personal financial planning:

1. The reduction in the money purchase annual allowance from £10,000 to £4,000, a change that potentially affected anyone drawing their pension benefits flexibly, but still making pension contributions. This was meant to take effect from 6 April 2017.
2. The reduction in the dividend allowance from the current £5,000 to £2,000 from 2018/19, a move which could cost a higher rate taxpayer up to £975 a year in extra tax.

Prior to the election the expectation was that a new Conservative government, with a larger majority, would launch a Summer Budget, reinstating the lost measures and perhaps adding some fresh post-election initiatives to a new Finance Bill. After the election matters became much less clear.

## Where are we now?

The background notes to the Queen's Speech revealed that there would be a Summer Finance Bill, although what it would contain was only vaguely outlined and no detailed timings were given. The Treasury can sometimes have a creative approach to seasonal dates. Matters are made worse by the fact that the House of Commons will be in recess from 20 July to 5 September and then shut up shop from 14 September to 9 October for what promises to be an interesting party conference season.

At least Mr Hammond has confirmed (to Andrew Marr, not Parliament) that there will be no summer Budget. The next Budget will be in the Autumn, assuming the government survives that long. It would be the first Budget of the new cycle announced last year by Mr Hammond and will be followed later in the Autumn by *another* Finance Bill.

## *ACTION*

*The uncertainty created by recent events has made some areas of financial planning difficult: changes which had been announced with specific start dates might reappear unaltered in one of those two Finance Bills due this year. The second Finance Bill might also include new tax-raising measures targeted at higher earners – austerity is out of favour and the Conservatives have never been afraid of borrowing ideas from Labour's manifesto if they seem popular.*

> ***The message today is talk to us before taking any action on the financial planning front. The political situation is very fluid, making it vital to be as up to date as possible before making any moves.***

## THE £50BN EXODUS

It is now nearly 40 months, two elections and five Budgets ago since George Osborne turned the pension world upside down with his pension flexibility proposals. The majority took effect from April 2015 and have had a dramatic effect on how benefits are drawn from personal pensions and similar money purchase pension arrangements. Statistics from the Financial Conduct Authority (FCA) released earlier this year revealed that amongst those accessing their pension pots for the first time, using pension flexibility is more than twice as popular as buying an annuity.

### The knock-on effects

The reforms introduced by Mr Osborne left the traditional final salary (defined benefit) pension scheme virtually untouched. Retirement benefits from such schemes remain largely inflexible: once the mix between pension and initial cash lump sum is decided, very little can change.

The original consultation paper on pension flexibility, published in March 2014, commented that'…the government recognises that the attractiveness of transferring from defined benefit to defined contribution may increase as a result of the changes to the tax framework for how defined contribution pension savings can be accessed'.

That has proved to be something of an understatement. Although transfers from nearly all public sector schemes have been effectively banned, one recent estimate suggested that £50bn had been transferred out of defined benefit pension schemes between April 2015 and May 2017 by 210,000 scheme members, an average transfer value of about £240,000 each. That near quarter of a million pound figure in part reflects the sharp rise there has been in transfer values since the start of 2016.

### Enter the regulator…

In June, over three years after the original flexibility announcement, the FCA issued a consultation paper on transfers from defined benefit schemes, proposing stricter advice requirements and a new form of benefit comparison which, at long last, accepts that most transfers will not now result in the purchase of an annuity. The regulator also subtly revised their stance towards such transfers. At present the FCA says an adviser should start from the assumption that "a transfer will be unsuitable". The proposals remove this default assumption and replace it with a statement in the FCA's Handbook that "for most people retaining [final salary scheme] benefits will likely be in their best interests and guidance that advisers should have regard to this".

The FCA says that this different approach stems from the fact that "…the introduction of the pension freedoms has altered the options available and for some consumers a transfer may now be suitable when it wasn't previously".

*ACTION*

*The fact that £50bn has been transferred out of final salary schemes is no reason to assume it is the right course of action in every instance. If you have private sector pension benefits from a former employer or a closed scheme of your current employer then, to paraphrase the FCA, you are probably best off leaving them there. However, that is not the same as saying you should do nothing. You may be one of those people for whom pension flexibility means a transfer makes sense.*

***Gather up the information you have on your old pension benefits and ask us to make an initial assessment. We can then advise you whether a more detailed analysis will be worthwhile.***

## THE END OF THE CHEAP STUDENT LOAN

Student loans were one of the issues that entered the spotlight during the election campaign. The Labour party proposed scrapping new tuition fees and reintroducing maintenance grants instead of maintenance loans. The proposals were by far the most expensive single spending commitment the party put forward, with an annual cost of £11.2bn.

### It did not happen…

Despite a higher turnout among the younger section of the population, Labour did not win enough seats to form a government and so when the new academic year starts in the Autumn, the existing student finance regime will still be in situ, albeit with different variants in each of the UK's four constituent parts. In England, tuition fees will rise to up to £9,250, with maintenance loans of up to £11,002 a year. At the other end of the scale, Scottish students studying in Scotland (but not elsewhere in the UK) have no tuition fees to pay, although most maintenance is provided via means-tested loans of up to £7,625 a year.

### Enter inflation

Although the government has abandoned the Retail Prices Index (RPI) for increases to state pensions and tax allowances, it has kept this outdated inflation index where faster-than-CPI rises are to the Exchequer's benefit. Thus, the interest rate on student loans is RPI-linked. For loans to English and Welsh students who started their courses after 31 August 2012, the rate of interest charged from September 2017 to August 2018 will vary from 3.1% (March 2017 RPI) to 6.1%. The highest rate applies until the April after a course ends and for those graduates whose income is £41,000 or more. With base rate at 0.25%, a 6.1% interest rate is not cheap.

### A difficult calculation, even for a graduate

Just because the interest rate is high, it does not necessarily make sense to clear a student loan as quickly as possible or, for that matter, avoid taking one in the first instance. Any outstanding student debt is generally written off after 30 years from the April following graduation. Until that magical day, repayments are based on 9% of income above a specific threshold (currently £21,000 in England and Wales and £17,775 in Scotland and Northern Ireland). A calculation that involves estimates of inflation and earnings for three decades is bound to have a potentially wide margin of error, even before you add in the possibility of government changes to the rules. In many instances graduates will see some debt written off in their early 50s, which could, with hindsight, make accelerated repayment a bad idea.

*ACTION*

*If you are concerned about the student debt burden on your children or grandchildren, talk to us about the planning options available.*

*Each case is different and needs a personal assessment. Maximising student loans might make sense for some, whereas clearing them off as quickly as possible is wiser for others.*

## CHINA COMES OF AGE

In June, an important decision was made about the future role of Chinese investment markets.

### The elephant in the room

China is the final letter in the BRICs (Brazil, Russia, India and China) quartet of emerging markets made famous by Jim O'Neill, the former chief economist at Goldman Sachs. His forecast of growth for China, originally made in a paper published in 2001, proved prescient. At the time, the Chinese economy was little bigger than Italy's. Today, China ranks as the world's first or second largest economy in terms of economic output (it depends on your chosen yardstick), boasts the second biggest global equity market and has the third largest bond market.

For all the country's heft, Chinese shares listed on China's two stock exchanges, in Shenzhen and Shanghai, are not included in the most widely used emerging markets index, the MSCI Emerging Markets Index. MSCI does have Chinese *companies* in that index, but they are listed in the USA or Hong Kong, not China. These offshore listings already represent just over a quarter of the Index.

### Review time

MSCI reviews the membership of its indices regularly and in 2014, 2015 and 2016 it rejected the inclusion of Chinese listed shares. The reasons revolved around corporate governance, market liquidity and heavy-handed intervention by the Chinese authorities. After each rejection China made some tweaks and hoped for better luck next time.

In 2017, better luck arrived and, at strike four, MSCI announced that 222 of the largest Chinese companies listed on the mainland exchanges would join the Emerging Markets Index from next May. They will not be given a full weighting, so will initially count for less than 1% of the Index. In part, this was to prevent too much market disruption, as an estimated $1,000 billion tracks the Index. MSCI's approach was also seen as giving the index provider leverage to encourage further market reforms in China, to be rewarded with increased weightings. A full weighting for Chinese shares, listed offshore *and* in China, would account for about 40% of the Index. At that point, the Index becomes more like a China and Other Emerging Markets index.

*ACTION*

*MSCI's long-awaited decision to include mainland China shares in its Emerging Markets Index is another example of the growing importance of Asian markets from the global standpoint.*

*The past year has been a lesson for UK investors in the benefits of having international diversification. If, like many private investors, you have little or no exposure to China, do talk to us about the opportunities that already exist to invest in the still fast-growing country.*