

Financial Reality Index – Q3 2007

October 2007



The Alliance Trust Research Centre's ongoing Financial Reality study shows that household budget pressures continue to weigh upon the consumer, despite favourable economic conditions. The 10 year study looks closely at the 'reality' households actually face.

The Financial Reality Index was constructed as a tool to measure the long and short-term financial health of consumers. It employs a wide variety of measurable variables, chosen to reflect important economic background factors, budgetary considerations and wealth accumulation and preservation. The index has been calculated on a quarterly basis over the ten year period since the beginning of 1997. During much of that time, it has shown a close correlation with the trend in consumer spending. This index is constructed using only measurable variables as the purpose is to measure the 'reality', rather than the 'perception', of household finances. Our model is constructed on the belief that the underlying strength of a consumer's financial situation is influenced by many factors.

The latest Q3 report records an improvement within two of the three sub-indices, and the Financial Reality Index has increased from 82.0 to 88.6. Although this is the highest level since Q1 2005, the index remains well below the critical level of 100 and has now been in negative territory for over three years. During Q3 increases were recorded in the Economic Background and Household Budget sub-indices, but the Net Wealth index decreased. The Household Budget component continues to weigh most heavily on the overall index.

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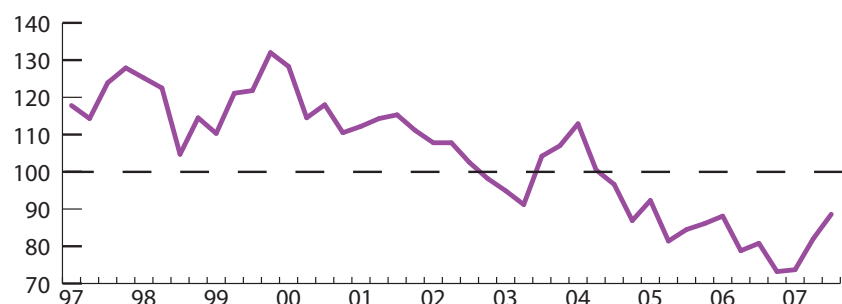
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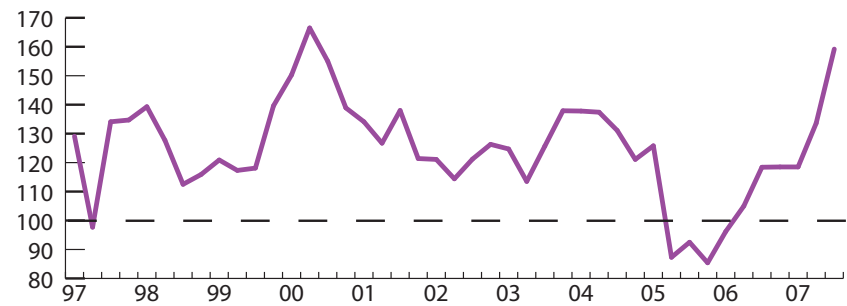
Financial Reality Index



Economic Background

The underlying strength in the economy helped to boost the Economic Background index. The economy has been growing at a relatively strong pace and this helped to sustain employment. The Economic Background Index remains the strongest component within the Financial Reality Index, and is at its highest level since Q2 2000, having increased from 133.6 to 159.2 in Q3.

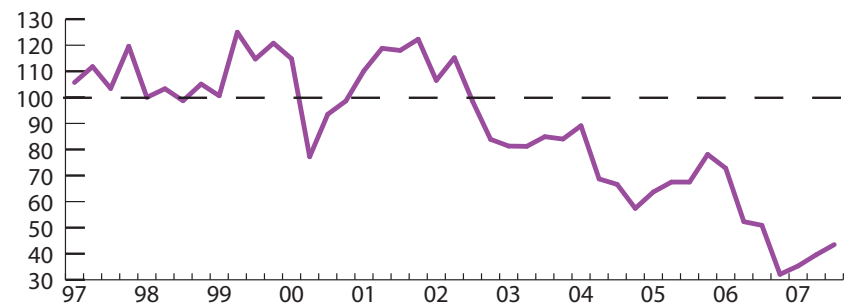
Economic Background



Household Budget

Despite a relatively favourable economic background, households continue to face considerable financial pressures. Households are being squeezed in terms of low real earnings growth, higher mortgage payments and council tax payments. These factors weigh heavily on household budgets. There have been some improvements in terms of basic good costs, which eased for a third quarter, and real disposable incomes, as inflation has fallen back. However, the biggest household budget pressure is still mortgage payments, which increased for a sixth consecutive quarter. The Household Budget Index improved only marginally over the quarter, rising from 39.6 to 43.5, but this is still the fourth lowest on record.

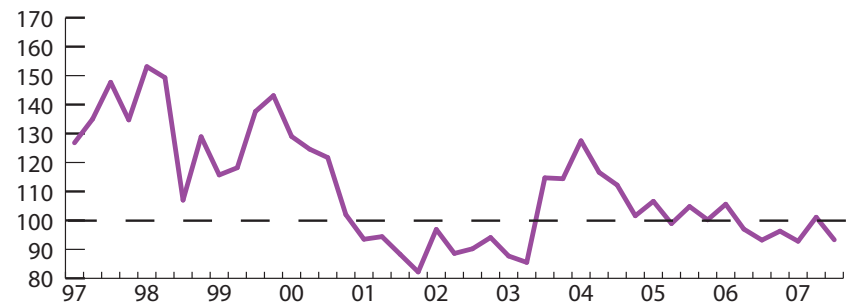
Household Budget



Net Wealth

House prices continued to rise in Q3, albeit at a slowing pace, and this continued to provide upward support. However, recent financial market turmoil reduced the gains from the equity market, pulling these closer to their long run average. Meanwhile, debt continued to build and this weighed heavily on households. As a consequence the Net Wealth Index decreased over the quarter, as the increase in house prices was more than offset by the impact of rising debt costs and lower equity market gains. The Net Wealth Index has fallen back below the critical level of 100, decreasing from 101.1 to 93.3.

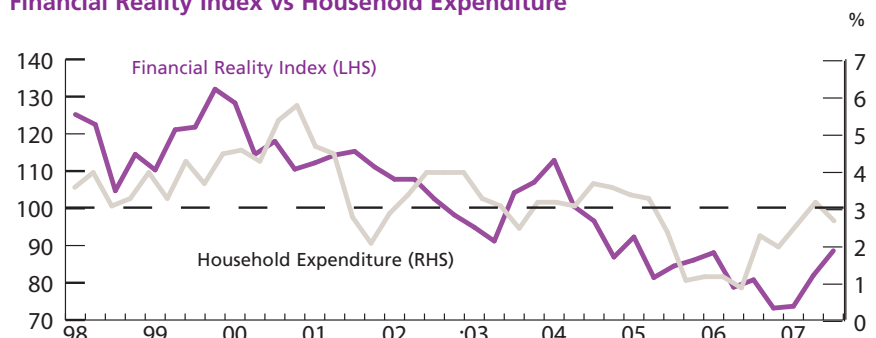
Net Wealth



Financial Reality Index vs Household Expenditure

Consumer spending growth fell back marginally over the quarter, but still remains out of synchronisation with the Financial Reality Index. The fact that the Financial Reality Index remains well below 100 points to further downside risks to consumer spending.

Financial Reality Index vs Household Expenditure



Sources: ONS, DCLG, CML, ECOWIN and Inhouse Analysis.