25th June 2010

Market Report

As we approach the mid-point of 2010, to the untrained eye, movements in the general UK equity market indices would have appeared to be largely uneventful with the FTSE 100 falling 4.3% from the start of the year to the present.

We have, however, experienced large gyrations in equity and bond markets resulting from continued uncertainty triggered from various sources (e.g. Chinese growth) regarding the global economic recovery, geopolitical sovereign risk concerns, oil problems in the Gulf of Mexico and credit ratings agency ‘threats’, to name a few.

Despite the fact that, from a company viewpoint, the economic and business macro and micro environment data continue to improve, consensus still favours the short to immediate term resulting in prolonged market volatility.

An example of this can be given by looking at the effect of the recent UK general election upon UK equity markets. The focus ahead of the election in the context of asset allocation was upon a potential fall in the UK government bond market, owing to an increasingly problematic UK public sector debt problem; and a hung parliament resulting in potential delays in tackling this problem; leading to a downgrade of UK government debt and subsequent falls in gilt prices.

This was completely overshadowed by further problems in Greece in relation to their own sovereign debt problems, resulting in a bailout package of some €750 billion put together by the other 15 members of the Eurozone.

The net effect was sharp falls in equity market prices and increases (in the short term) in UK government gilt prices which, perversely, were perceived as a safe-haven by investors during this period.

At present, with equity markets having largely risen back to the levels seen just before the latest bout of Greek panic, it is now prudent to look forward to the second half of 2010 in order to pre-empt further market movements.

In previous investment letters we have stated that, whilst economic and business indicators continue to show signs of improvement, the key to further improvement and the removal of public sector economic stimulus measures remains the consumer.

A major concern here is that (from a US perspective) whilst leading economic indicators such as weekly jobless claims numbers have shown significant improvement, reducing from an average number of over 600,000 per week last year to levels of around the 460,000 mark (which is a level consistent with 100,000 or more net job losses per week), these numbers imply that so far the economic recovery has been business-led in the absence of significant job creation. With major corporate profits about to be squeezed going forward, investors fear slowing multi-national business growth in the second half of the year, bringing the increasing prospect of a double-dip recession.

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A major area is often overlooked by these indicators which will provide important information in helping to anticipate economic growth expectations in the second half of 2010 and beyond. Small companies in the US are a major source of job creation, accounting for over 75% of new jobs in the US economy. Numbers have fallen in areas such as residential housing starts and retail sales, and rising employment will have a significant impact here.

Small businesses remain in a depressed state at present with the National Federation of Independent Business indicating in its June survey that the majority of small firms are not increasing wages with poor sales cited as a worry for these firms. However, optimism is improving.

With the above comments in mind, we remain cautious in our approach to current market conditions. That said, we continue to have a long term approach within the current 'commentator noise' of the short term and seek to exploit these views to the benefit of our clients.

At present, whilst we do not invest in direct equities in order to reduce risk specific to individual companies, one area where we can give a good example of short term noise is BP Plc.

Due to panic, BP has lost roughly half of its value in a matter of four weeks with the inexplicable question of bankruptcy being raised in some quarters. For the record, the company is now priced at approximately five times its historic annual earnings and, assuming that its dividends are reinstated next year, it will have a 10% dividend. It has the fourth highest revenues of any company in the world and also earns the fourth highest profits behind Gazprom, ExxonMobil and Royal Dutch Shell. Operating profits are forecast to be approximately $34 billion for 2010 ($93 million per day) with net income of $22 billion.

One major point being overlooked is that whilst we do not know the total cost of the oil spill to BP, from past experience we do know that the clean-up costs (legal liabilities and fines that the company will incur) will be spread over many years, allowing the company to earn the funds to pay these fines. Using an example of the Exxon Valdez oil spill, the US Supreme Court did not make a final ruling on damages until 2008, more than 19 years after the spill. Short term noise would have us believe that the total costs would be payable in the near term, which would impact greatly upon the profitability of the company going forward. Such noise creates tremendous investment opportunity within a very difficult market.

MPL Asset Allocation

Cash

Fixed term deposit rates continue to remain at low levels due to the loose monetary stance currently being taken by the Bank of England.

Due to the continued expense of money market borrowing for private banking institutions such as Close Brothers Group Plc when they require liquidity, we are still able to achieve rates of interest for our lower risk clients of 2% over a 6 month period.

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Fixed Income

UK Treasury Gilt Market
Our index linked gilt holdings have been supported by a persistent level in the UK retail price index of over 3%; an increase in UK wage settlements and the recent turmoil in Europe. We should see some further price appreciation in the short term, resulting from the coalition government's plans to increase Value-Added Tax to 20% from January 2011.

Emerging Market Debt
Chile's recent credit ratings agency upgrade has enhanced the valuation of our emerging market debt holdings, which have appreciated in value in recent weeks, as investors have also moved funds away from the embattled European region into emerging market bond markets. These moves have given further validation of our investment here, as attitudes regarding the problems from which emerging nations suffered in the 1990s fade and debt problems in developed nations persist.

UK Corporate Bond Market
We continue to retain our current UK corporate bond weightings for clients in the knowledge that many investment grade corporate bond issuers have reported improved earnings and cash flows, which will make it less likely that they will default on their bonds. The subsequent effect here is an improvement in their credit standing, which will further increase bonds' prices whilst continuing to pay attractive yields.

Equity

Over the past few weeks, we have marginally increased equity holdings within client portfolios to take advantage of the recent market weakness. At present, this is the most volatile area of all portfolios at ratings below average risk and above, and we anticipate that over the next few quarters, this will also be the most active area of these portfolios as we attempt to take advantage of continued volatile market conditions going forward.

May we take this opportunity to welcome our new Investment Assistant Edward Heath-Thompson. Edward has recently joined our investment team in order to help us to further develop our discretionary investment management service to our clients.

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