

8th October 2010



Market Review

As we enter the third quarter of the year, we do so having experienced a sharp rally in global equity markets, resulting once again from volatile investor sentiment.

At the end of the second quarter, markets had fallen as a result of further European sovereign risk concerns and talk of a double dip recession. Weekly and monthly economic data plus better than expected second quarter corporate earnings results in the subsequent period went some way to temporarily dispel that consensus, leading to the initial stage of the market rally we now experience.

With the third quarter corporate earnings season now upon us, financial markets now face a somewhat artificial situation. The Inventory rebuilds stage of the economic cycle now in its latter stages. And central bank efforts to avoid the prospect of a double-dip scenario have come to the fore again. This is due to the expected period of slower economic growth after this stage, prior to an increase in consumer led manufacturing growth.

Owing to the recent Bank of Japan “comprehensive easing” commitment to pump more funds into its struggling economy and keep rates virtually at zero, speculation has now increased that the Bank of England and the US Federal reserve will follow suit.

The effect of this speculation is four-fold.

Firstly, with virtually the entire original central bank financial stimulus filtering through to major corporate entities, a second round of stimulus will ultimately (and maybe falsely?) enhance corporate earnings bolstering financial markets.

Secondly, with the prospect of further money being printed and injected into the monetary system by the Federal Reserve, this has had a negative impact upon the US Dollar, which has fallen in value against other major currencies. The resultant effects here are that commodities which are valued in US dollars have become cheaper to buy in other major currencies, bolstering the demand for these assets which will serve to enhance the earnings of corporate businesses in this area (Such as Mining and Oil companies).

Thirdly, with the second point in mind, further printing of US dollars and the subsequent devaluation of the US dollar has led to a reduction of the level of confidence in the US Dollar. This is a key reason explaining the rise of over \$100 per ounce seen in the price of Gold over the past month.

Finally, in normal circumstances, equity and bond markets (in developed Western markets) have a relatively negative relationship, with the prices of these assets moving in opposite directions. Because further stimulus measures would involve the purchase of government bonds by the Central banks involved, a large buyer is now in the government bond market, which has had to effect of increasing existing government bond prices in tandem with the equity market rise.



With the recent equity market rally now long in the tooth and looking somewhat overbought, in the immediate term the points discussed above could potentially be overshadowed by the results of the third quarter earnings reporting season.

Recently in market areas such as the financial sector, Analysts have been reducing their earnings estimates owing to a slump in areas such as trading activities.

This being a notoriously volatile period of the year, if earnings do not meet expectations in this quarter, stock market price valuations will have to be adjusted to reflect the prospect of this event occurring, potentially leading to a sharp decline in equity markets.

In recent weeks we have been busy taking some profits resulting from the financial rally we are experiencing. Client portfolios have been positioned in a protective manner, in order to negate some of the effects of any market pull back in this earnings season.

With the US Mid-term elections being decided in November this year, it is unlikely that the US Federal Reserve will contemplate implementing any further stimulus measures until the new US legislature is in place.

If the third quarter earnings season does have a negative impact upon equity markets, we will be in a position to increase the equity weighting in portfolios again at lower market levels, in order to take advantage of the artificial effects of any stimulus measures as discussed above.

Owing to the continued volatility in financial markets, and in consideration of all of the points discussed above, our focus remains upon the consumer in developed western economies, whose influence as yet has not been felt, but the key to economic revival.

MPL Asset Allocation

Fixed Income

UK Treasury Gilt Market

In line with the protection of all portfolios, we have increased our index linked gilt allocation by 5%, with the purchase of a UK Treasury Index Linked 1.25% 2027 holding. With a higher sensitivity to market negative equity market movements than the other Index Linked holdings in client portfolios, owing to the longer maturity of these gilts, they will aid the protection of portfolios in the event of a market sell-off.

UK Corporate Bond Market

In line with our comments in our last letter to you, our current UK corporate bond weightings for clients have been maintained and in the current climate, should also benefit from any proposed central government stimuli.



Equity

In the last month we have reducing equity holdings from an overweight to a neutral stance, taking advantage of the current equity rally. Some profits have been taken in the UK equity income, global equity and Asia excluding Japan sectors.

We have also added some protection to the UK equity portion of Medium Risk and above portfolios, by adding an exchange traded fund (ETF) based upon the FTSE 100 index. This ETF has an inverse relationship to that of the FTSE 100 index, which will move upwards in the event of a fall in the underlying index hence offering some protection to the remaining equity holdings in this area.

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