

1st September 2008

Market Report

With the traditional summer holiday stock market malaise - characterised by low volume, lack of news flow and general inactivity - coming to an end for another year, the MPL Investment Department have used this period as an opportunity to look at the current global economic environment, in an effort to reaffirm our view of global markets, as market participants return from their summer vacations and the pick-up of activity in September begins.

Below we give a brief overview of our current thoughts on the major global economic regions which will have an impact upon our client portfolios, as we move towards the end of the current year.

Asia Pacific and China

Over the last five years, the Asia Pacific region has benefitted significantly from the Chinese growth story and any capital gains which have been made in this sector should be locked in as the region now faces the headwinds of slower Chinese and indeed global economic growth.

What is being seen in China and indeed the whole Asia Pacific region now is the effect of a contraction in western demand finally having an impact upon Chinese growth. Whilst China has rapidly increased capacity in order to deal with this demand, the orders which were there maybe two years ago are no longer there.

Now signs are being seen of a decrease in Chinese growth estimates, and internally an increasing number of business foreclosures and unemployment.

Taking this into a global picture, the situation in Asia Pacific will only improve, once the global growth lead from the US and European economies strengthens. In particular, positive signs from the US could well be the lead indicator of global economic improvement.

Europe excluding UK

With a strong manufacturing and export-led economic base, the Continental European economy had seemingly appeared to have avoided the worst of the economic and financial problems seen over the past year.

This illusion has recently been shattered as recent euro-zone second-quarter growth figures showed a 0.2% contraction, the first negative figure since the euro's inception in 1999. With slowing growth set to continue, the euro zone is set to become the first major economy in the developed world to post two successive quarters of negative growth and hence fall into recession.

The combination of high raw material prices, past interest rate rises, a high euro and the credit squeeze have been the major causes here, having the knock-on effects of falling consumption (as higher inflation and a falling supply of consumer credit has eroded real income), falling exports (foreign orders for German engineering goods had fallen by 7% year-on-year in June) and falling corporate investment due to lower demand for company loans.

This situation is still in its early phase as the European Central Bank will not provide any economic stimulus until it sees evidence that the danger to European inflation from high oil prices has passed.

This may well be too late to stop the European economy shrinking further as the weakening economic outlook forces companies to cut jobs and reduce investment in order to survive.

The Global Economy

The higher food and energy price-driven inflation, which has undermined consumer confidence and led to decreased consumer spending with resultant negative economic effects, has not been confined to developed western economies, but has enveloped the global economy.

In developing nations, consumers, who until now have to an extent have been shielded from the recent spike in food and energy costs by government fuel and food subsidies, have suffered as governments have slowly begun to roll back these measures, as the cost associated with subsidising these basic necessities has become increasingly prohibitive in the face of increasing commodity prices.

Globally we are still in the early to mid-stage of the cyclical downturn in economic prospects. Currently from a globally based investment viewpoint, a bias to capital preservation should be favoured over that of aggressive growth, with investment positioned in sectors such as non-cyclical consumer services and utilities, where you are being paid whilst you wait for the economic outlook to improve.

These sectors are negatively correlated with the profit cycle, as their cash flow and dividend payouts are stable throughout the economic cycle, making them attractive as profits fall in economic downturns. Furthermore, these sectors are similar to corporate bonds in that, as governments stop hiking interest rates when inflation peaks; the income yields on these holdings become more attractive against falling interest rates.

The United States

Unexpected signs of strength in the US economy have been seen in the last few days, as US second-quarter GDP growth figures have been revised upwards from an initial estimate of 1.9 per cent to 3.3 per cent.

The effects (until recently) of a weakened dollar boosting exports, swift monetary policy measures taken by the Federal Reserve in cutting interest rates, the recent retreat in oil prices and the fiscal measures taken by the US Government have all had a part to play here.

We remain cautious with regard to the US as weakness persists in the housing and job markets. Further headwinds will be faced as we move towards the end of this year, as the fiscal stimulus from the US income tax rebates begin to fade, and export growth cools in response to slower growth abroad and the recent recovery in the US dollar.

The US Stock market is heavily weighted in early to mid-cyclical companies such as information technology and general industrial companies and has a low weighting towards financial companies. As such, the broad market generally underperforms in the conditions we are currently seeing with this gearing towards the early to mid-growth stage of the economic cycle.

Taking the above comments on board, it could be some time before we see a return to consistent, stable economic growth in the United States, hence investment allocations made in this area should still be focused upon defensive non-cyclical areas such as consumer services and utilities.

The United Kingdom

With the current UK economic climate in mind, the Bank of England will only react with monetary policy stimulus once firm evidence of slowing inflationary growth is seen.

We believe that this will occur in the within the next year for the following reasons:

- The economic slowdown will lead to spare capacity being created in the economy, reducing pressure on inflation. Frankly, workers will not push for higher wages when unemployment is on the increase.

September 2008

- The fall in the supply of credit we have seen over the past 12 months will lead to downward pressure on inflation.
- Oil was at \$70 per barrel a year ago – it's now \$120. For oil to have the same impact on inflation next year, it needs to reach around \$220 – possible but unlikely. If energy and food prices remain at current levels, they will pull the overall inflation growth number down as the rises seen in the last year will not be replicated.

This should result in the Bank of England cutting interest rates from current levels, leading to economic stimulus. With the financial sector in mind, this should lead to a loosening of recently tightened credit policy (thus increasing liquidity), which in turn will benefit early cyclical areas of the market such as the financial sector, basic industries (such as construction) and consumer discretionary sectors.

MPL Asset Allocation

Cash

The spread of fixed term money market deposit rates has tightened since June with deposit rates ranging from 4.506% per annum (for one week deposits) up to 5.720% per annum for a 12 month fixed term deposit. This reflects the fact that liquidity has improved vastly over the past few months, although a high level nervousness in credit market remains.

Fixed Income

Gilt markets have been extremely strong since our last letter to you, with yields moving down from a level of 5.3%, to 4.5% representing capital appreciation across the gilt range in client portfolios of approximately 2-3%.

This suggests that the interest rate expectations in the general UK market had indeed been overstated as discussed in our previous letter, with the bond market now pricing in two interest rate cuts by the Bank of England going forward.

With prices in the Gilt market rapidly approaching the recent high levels seen in March, if these levels are achieved again, it will lock in gains made here, in consideration of the fact that income coupons ranging between 2-2 ½% are due to be paid across the range of Gilts in early September, potentially giving a total return on this asset class in the period between 5-6%.

A keen eye is still being kept upon the corporate bond market - in recent months this sector has suffered as a result of the global economic slowdown, a (now evident) rising level of company defaults and inflationary concerns regarding rising food and energy inflation.

We still expect inflation to moderate as we approach the year end. Coupling this with further evidence of the effects of the economic slowdown (rising unemployment and a falling property market) and company defaults near their historical average of 5% (currently 3-4%), the resultant effects should benefit the corporate bond market as investors take advantage of the yields currently available in this asset class.

Corporate bonds will benefit not only from the attractive yields available here, but also from the resultant reduction in the risk premium for holding these assets in the deflationary conditions we will see going forward, and this will lead to capital gains being made in this asset class.

Equity

The FTSE 100 has fallen from a level of 5,667 at the date of our June letter, with the market level currently at 5,629, displaying a distinct lack of tangible activity in the period. As the prospect of recession looms ever larger, we expect the market to move downwards upon receipt of further weak UK economic data in the short term.

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