

19th July 2009

Market Report

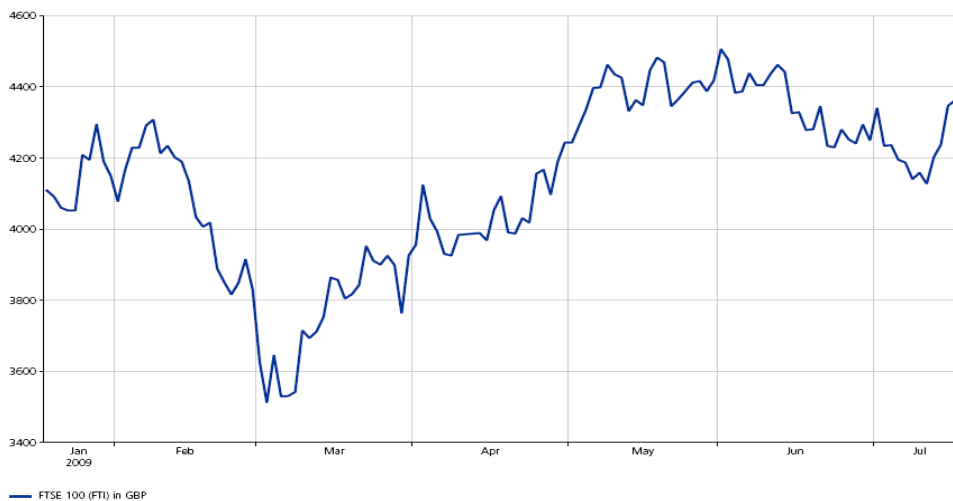
In the first half of this year, global financial markets have been characterised by constant changes in expectations/sentiment regarding the underlying economy in a sequence of severe recession in January, major global depression in February, then back to severe economic recessionary expectations in between March and May, with the prospect attached of (the now worn out expression) “green shoots”, coming now to current expectations of an end to the US recession at the year end, accompanied by guesswork regarding global government “exit” strategies.

The more concrete plans delivered by the US government in mid-March, to tackle the global financial and economic crisis, have served to reassure investors and the general public alike that global financial melt-down has been averted.

The effect of the global governmental response to the current economic crisis since early March has been profound as seen in the chart below.

FTSE 100

6 Months to July 2009



Global equity markets have rallied strongly, in many cases rising over 20%, as many investors initially focused upon assets that would benefit from the longer term inflationary growth aspects of the central governments’ policy responses.

Companies that typically benefit from the early stage of cyclical economic recovery, in sectors such as the banking, industrial, mining and commodities industries, have rallied sharply as investors have rotated out of defensive sectors such as the pharmaceutical industry. It must be noted, however, that these cyclical sectors suffered badly earlier in the year, when market sentiment changed from the expectation of a major global recession to one of a severe global depression, and are now just under the market valuations seen just before the collapse of Lehman Brothers in September 2008.

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With the volatility we have experienced in economic markets over the past six months, and an expectation that a potential end of the US recession is drawing nearer, we remain cautious.

We accept that the worse of the lagging effects of the financial and economic crisis have been seen. However, investors and the general public alike now have to come to terms with the resultant fall-out from this crisis and the following factors that may hamper a potential early end to the current economic recession.

Unemployment continues to rise, albeit at a slower pace, as companies struggle to survive and wage growth remains muted at best. Whilst there are tentative signs that valuations of UK residential housing have begun to stabilise, lending in this area remains weak, which is a further sign that banks are not lending.

The fall-out from the central governments' policy response to the financial and economic crisis could be a future of higher taxation (to meet the increasing level of public debt incurred throughout this period), re-regulation (to meet the excesses of the previous bull market) and greater public sector involvement in the private sector, which could hamper future free market trade and ultimately economic growth.

As a result in the short term, we question whether the market rally we have experienced (within developed nations in particular) in the last three months has resulted in fair market values that are properly reflective of the outlook for a future economic environment that will be characterised by lower growth and smaller margins.

Indeed, in consideration of all of our concerns raised above, we have taken advantage of the recent equity market rally by reducing client exposure to the cyclical area of the UK and global equity markets, in favour of moving higher up the capital structure to companies in developed nations which should prosper in a lower growth economic environment, with the aim of securing good income streams to benefit capital growth as credit conditions normalise and reducing the levels of volatility and risk in client portfolios as conditions remain uncertain.

MPL Asset Allocation

Cash

Fixed term deposit rates have remained at low levels that are a direct result of the significant interest rate cuts which were made throughout the first quarter of this year.

Whilst we have addressed some of the problems related to the risk and rewards of achieving increased levels of income on our cash holdings for clients, as discussed in our last letter to you, we accept that this problem will continue to persist for some time yet. As a result, at present we are looking for near-cash alternatives that should help us to alleviate the problem further.

Fixed Income

UK Treasury Gilt Market

We have added a 5 year conventional Treasury gilt to client portfolios to take advantage of an annual yield of over 2.2% on this investment, with a potential pull to par of 1.5% in the event that there is a further deflationary shock in the short term.

Whilst we continue to hold our index-linked Treasury positions (over the longer term), which have benefited significantly from a technical position of being oversold at the point of purchase in December 2008 with all other asset classes, factors such as the increasing levels of unemployment, muted wage growth and the as yet unanswered question as to whether quantitative easing policy is working remain very much at the forefront, and the deflationary conditions being experienced at present could persist for longer than expected in the short term (2-3 years), thus benefiting the conventional gilt market.

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UK Corporate Bond Market

We have increased client portfolio weightings in the UK corporate bond market area from 4% to 10%, as we have sought to take advantage of easing credit conditions in this area. This has enabled us to take on more risk in this area by investing in funds focused upon investment grade bond issues which are lower rated at AA and BB rather than AAA, but which will potentially benefit further from a current sentiment regarding company default and bond recovery rates which we view as over-estimated. With yields of over 6% available at purchase in this area and potential capital gain as credit conditions improve, we feel that these factors outweigh the potential effects of high inflation in the future upon fixed coupons in this area.

Equity

In reducing our exposure to the funds that carry a higher weighting of cyclical growth companies within them, within the UK equity income sector we have maintained our focus upon funds favouring large-capitalised, defensive companies with low leverage.

An interesting development here of late is that, whilst we are of the belief that we are entering a period of lower economic growth, there are currently opportunities within the equity sector, whereby special situations that normally tend to emerge in the small to mid-capitalised UK equity markets are now available in the larger capitalised UK equity market arena. Hence, these funds can take advantage of the opportunities here.

At present, there are large businesses in industries with usually high barriers to entry (a lot of which are now unloved, such as banking) that have so far navigated themselves safely through this economic crisis and have capitalised on the failings of their competitors. As a result, they have benefited from increased market share at a very low cost, which has directly impacted upon their bottom line and will ultimately result in increased market valuations and capital gains for investors in this area.

A further plus in this area is that many of these companies are cash-generative with strong balance sheets and currently paying attractive yields to investors, so that you are being paid whilst you wait for this increased market valuation to develop over time.

In many respects, we are now beginning to see some stabilisation in the global economic business cycle. There appears to have been a major shift from the panic, which was characterised by the indiscriminate, violent swings we have seen in asset valuations over the past nine months, to a greater emphasis on a normalising economic business cycle and the fundamental asset valuations which result from this environment.

Hopefully this process of stabilisation will continue, giving us greater clarity in the planning of our asset allocation strategy.

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