

June 2008

23<sup>rd</sup> June 2008**Market Report**

Global stock markets have drifted downwards from the recent highs seen over the past month, as tangible examples of the effects of the global slowdown are now being recognised.

There has been rising uncertainty and concern regarding increasing global inflation and the attached difficulties of managing the slowdown in the global economy as a result.

With these problems in mind, short term opinion regarding a potential increase in interest rates from global market participants has placed such a firm focus upon Central Bankers' monetary policy-making decisions going forward that increased levels of volatility and indeed opportunity have arisen.

What perhaps is being forgotten here is that these decisions are being made with a medium to long term view, the effects of which will not be seen overnight.

Putting recent events into perspective, the Bank of England Monetary Policy Committee have three major concerns regarding inflation:

- Firstly, the ultimate size and duration of the pickup in non-wage costs, e.g., energy and raw material costs;
- Secondly, the extent to which consumer-facing companies pass these costs on through higher prices, or absorb them by pushing down on labour costs or by accepting lower profits at a time of slowing demand and rising spare capacity; *and*
- Thirdly, the degree to which persistently above-target inflation in the near term raises the public's medium-term inflation expectations, putting upward pressure on wages and prices.

These concerns will continue to be answered over the next six to twelve months, as the major slowdown in global economic growth now under way is a result of the bursting of the housing and construction bubble, the tightening in the availability of credit and the increase in the cost of credit caused by the North American credit crunch impacting negatively upon aggregate demand, output and ultimately capacity with deflationary effect.

The spectre of increasing unemployment looms large as the labour market has weakened. Rather than consumer-facing businesses accepting lower margins through increased non- wage costs and slowing

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demand, increasing unemployment figures suggest that they are pushing down labour costs through redundancies.

This in itself would suggest (from a private sector viewpoint) that employees will be less inclined to demand increased wages for fear of being made redundant.

The most important inflationary concern regards potential upward pressure on wages in the public sector. If those making decisions about wages begin to expect higher inflation in the future, this could result in increased wage demands which would have an inflationary impact if granted.

With the above factors in mind, avoiding any further wage and price shocks, inflation is expected to peak around the end of this year before falling back towards the Bank of England's 2% target.

This should ease the difficulty faced by the Monetary Policy Committee in tackling the economic slowdown currently seen, although this time lag means that households, businesses and ultimately financial markets have a lot more pain to experience yet in the coming months.

### **MPL Asset Allocation**

#### *Cash*

Fixed term money market deposit rates have normalised over the past month with deposit rates ranging from 4.521% per annum (for one week deposits) up to 6.227% per annum for a 12 month fixed term deposit. Whilst these rates now correctly reflect the time-adjusted risk attached to depositing funds for these periods, the high interest rate for locking funds into a money market deposit fund for a 12 month term reflects the fact that the period of cheap money is well and truly over.

#### *Fixed Income*

The recent opinion regarding a potential increase in interest rates from global market participants discussed earlier in our review of current markets has had a huge impact upon the UK conventional gilt market.

As a result of these views, a belief developed within financial markets that UK interest rates would have to rise sharply in response to a rapid increase in inflation. Hence conventional gilt yields rose sharply to compensate for this, i.e., non-inflation-linked gilt prices fell.

In the belief that this view was somewhat misconstrued, we took a small window of opportunity to add to our recent purchases of UK Treasury 4¾% 2020 and UK Treasury 4% 2016 gilts below par. Adding three further gilts at the shorter (interest rate-sensitive) end of the gilt market, we purchased the UK Treasury 4½% 2013, the UK Treasury 4¼% 2011 and the UK Treasury 4¾% 2010 gilt stocks.

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We have already seen some benefit from these additions, as market reports over the past week suggest that the market's interest rate rise fears have been overstated.

### *Equity*

Having recently reduced the equity portfolio weighting for our clients across the board to levels under 35%, in line with the UK market decline, we have taken the opportunity to add to our existing holdings of UK commercial property investment trusts, taking them up to a 3% allocation.

The story of this commercial property investment remains the same with void periods low at 2.1% of Expected Rental Value (versus a current industry norm of 8.1% per annum). The average lease term for the trust has risen over the past five months from 11 to 13 years, through recent lettings and lease extensions of existing tenants.

With a negative level of gearing in the fund, a potential fall in commercial property asset values of 20.2% at a market price of 70 pence per share has already been priced into the market value of the investment trust, which has a current net asset value of 87.7 pence per share.

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