31st October 2008

Market Report

The monetary policy stimulus hoped for in our last letter to you on 7th October was seen within hours of this letter being sent to you, with a 50 basis point cut in the UK base rate by the Bank of England on 8th October.

Attached to this policy stimulus, further measures (representing the largest UK government intervention in financial markets since the outbreak of the Second World War) were made by the UK Government, designed to address concerns over banks' capitalisation, caused by liquidity problems and the perception of financial default in global money markets.

As quoted in the recent financial stability report published by the Bank of England, there are three elements to the financial support measures announced.

Firstly, the UK government will support a recapitalisation scheme for UK banks and building societies (so far, Abbey National, Barclays, HBOS, HSBC Bank plc, Lloyds TSB, Nationwide Building Society, Royal Bank of Scotland and Standard Chartered have confirmed their participation in the scheme).

The banks and building societies involved will have to increase their Tier 1 capital (the core measure of a bank's financial strength) by an agreed amount, with the government subscribing capital in the form of preference shares (higher ranking than ordinary/voting shares, carrying a dividend payable before that of ordinary shares and, in the event of bankruptcy, payable in assets after debt holders and before ordinary shareholders) or ordinary shares if requested.

In the case of building societies, which are mutual organisations, the capital injection will take the form of permanent interest bearing shares.

Institutions receiving government capital will be required to meet certain conditions on dividend policies and executive remuneration, with commitments being made to support lending to small businesses and home buyers.

Secondly, institutions taking part in the recapitalisation will have a government guarantee upon any chosen senior unsecured debt instruments with a term no longer than three years, issued within a six month window from 13th October 2008. The government will charge a commercial fee for each issue that they guarantee. These issues include Certificates of Deposit, commercial paper and senior unsecured bonds and notes denominated in sterling, euro or US dollars. This guarantee will terminate on 13th April 2012.

Thirdly, the Bank of England's Special Liquidity Scheme has made at least £200 billion available to banks and will conduct auctions to lend sterling for three months and US dollars for one week against an extended range of collateral until market conditions stabilise.

In the United States, the US Government extended its original proposals under the Emergency Economic Stabilization Act of 2008, with at least US$250 billion of the US$700 billion voted under the Act now available to recapitalise US banks. The balance, as originally proposed, is available to purchase distressed assets.

The recapitalisation is in the form of preference shares carrying an initial coupon of 5% and rising to 9% if not redeemed in five years' time. The amount of this capital injection has already been announced for some banks. In addition, the Federal Deposit Insurance Corporation increased its deposit insurance from US$100,000 to US$250,000, offered for a fee to insure the entire amount of each non-interest bearing account, and offered for another fee of 75 basis points per annum to insure senior liabilities of a bank.

In Europe, while differing in technical details from country to country, many central governments have also sought to bolster capital ratios and provide some guarantees for bank debt instruments.

France has made available €41 billion to recapitalise banks and offered to provide €320 billion of funding on a secured basis. Germany offered €130 billion of capital for its banks and offered, for a fee, to guarantee directly up to €400 billion of bank debt.

Currently looking at the money markets, we have seen the interim effects of these global cash injections.

The London interbank offered rate, or Libor, that banks charge each other for three-month loans in dollars has fallen from 4.82% down to 3.42%, its 13th straight decline in recent days. The comparable euro and sterling rates have fallen from 5.4% to 4.85% and 6.3% to 5.9% respectively.

Whilst these rates are still at elevated levels, this is a sign that the strains in the money markets are beginning to ease (albeit at a slow pace), as the perceived probability of bank defaults has fallen and counterparties have shown tentative signs of increased willingness to lend to banks on an unsecured basis.

In response, the FTSE 100 has gyrated within a 500 point range throughout this period, as the major focus of financial markets has turned back towards the difficulties facing the global economy and the effectiveness looking forward of the recent monetary policy decisions made by central governments around the world.

Due to the indiscriminate and unprecedented conditions within which all sectors in global equity markets have been sold off recently, there are now opportunities available for the long term investor in these markets.

With the FTSE 100 now yielding 5.41% against a UK Government 10 year Gilt yield of 4.43%, we are hoping that there is now a differentiation between sectors within equity markets, which will be capable of weathering the difficult conditions currently being experienced, and those which are struggling, with a correction to (currently oversold) valuations resulting.

MPL Asset Allocation

Cash

Fixed term money market deposit rates have eased sharply in line with the falls seen in the London interbank offered over the past three weeks, with the indicative one week rolling deposit rate falling from 4.947% per annum pro rata to a current level of 3.899%.

With deposit rates now beginning to fall, when the (still evident but declining) current uncertainty and risk aversion in financial markets begins to stabilise, investors will have to begin to re-evaluate the returns they are currently receiving from cash deposits, with an inevitable shift towards asset classes producing better returns.

Fixed Income

The Gilt market remains at elevated levels, albeit slightly below the highs recently seen, but still overbought. What we are now seeing is a split between the short end of the gilt market (Gilts with maturities under five years) and the medium to long term end of this market.

Prices at the short end of the gilt market have increased in response to the emergency monetary policy measures taken by the Bank of England, namely the 0.5% cut in the UK base rate on 8th October.

The longer end of the gilt market has sold off, reflecting the fact that the recent injection of liquidity by central banks into the financial system will have an inflationary effect upon the global economy in the longer term.

Whilst we still believe that the Gilt market is overvalued at present, we continue to monitor the long end of this market for any potential overshoot on the downside here.

Equity

Our views remain intact and indeed are slightly enhanced regarding the UK Equity market, with the FTSE 100 index now priced at 8.61 times company earnings yielding 5.41%.

With deposit rates in the money markets falling due to the recent central government action, the equity market is the asset class most likely to benefit as a result of this policy.

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