

October 2008

7th October 2008

**Market Report**

Following on from the collapse of Lehman Brothers Holdings Inc. and Washington Mutual Inc; the nationalisation of Fannie Mae, Freddie Mac, American International Group Inc. and Bradford and Bingley (here in the UK), the sales of Merrill Lynch & Co., Wachovia Corp. and HBOS, the major focus regarding the problems associated with the current credit squeeze has now turned to continental Europe.

Over the past week, the German government has agreed to a 50 billion euro rescue package for commercial property lender Hypo Real Estate Holding AG after its stock slumped 89 percent this year. BNP Paribas SA, France's biggest bank, will take control of Fortis Bank's units in Belgium after the failure of a government rescue of the Brussels and Amsterdam- based company. In Iceland, the government is reportedly arranging a 10 billion euro injection into its banking system and in Italy UniCredit shares were suspended on Monday after they slid 14 percent following the bank's abrupt U-turn to boost capital by 6.6 billion euros.

UniCredit, battered by investors to second place in Italy below Intesa Sanpaolo, is the most exposed of the Italian domestic banks to the global crisis, with over half its revenues coming from outside Italy's ultra-conservative lending market. UniCredit's board approved a 3 billion euro share issue at a special meeting on Sunday and agreed it would pay out its dividend in shares instead of cash for 2008 as it aims to hike its Core Tier 1 ratio this year to around 6.7 percent, over previous forecasts.

Amid what is unprecedented market turmoil, there exists in effect a total global 'freeze' in credit markets, which to a large extent still remains largely unaddressed by global central banks and government.

Whilst the Troubled Asset Relief Program, or TARP, which allows banks to sell toxic assets above current prices, driving down yields on some bonds relative to benchmarks, was finally signed into law by US President George W. Bush on Oct. 3, the prospect for a coordinated effort to stabilise financial markets in Europe at present remains fragmented and unclear.

European finance ministers failed to agree on steps to shore up the banking system hours after their countries' leaders pledged to do whatever was needed to restore confidence as the continent's stocks fell the most since 1987.

There was little support for the suggestion from France and Italy that Europe create a U.S.-style bank rescue fund at yesterday's monthly meeting of euro-area finance ministers in Luxembourg.

Pledges were made by German Chancellor Angela Merkel and French President Nicolas Sarkozy to guarantee savings accounts.

Some criticism is being levelled at Ireland over a plan to protect not only deposits in six local banks, but also loans they have taken until 2010.

A point must be noted here that, with leverage being the key factor presently under focus, the Irish government is assuming potential liabilities of €550 billion, whereas existing government debt is €40 billion and overall Gross Domestic Product is €160 billion.

The Irish financial sector also has a loan to deposit ratio of 150% compared with 130% in the rest of the European Union, and has been marked down heavily due to its reliance upon the inter-bank lending market.

Such uncertainty has added to the current turmoil being seen, as the credit freeze and fragmented central government response have had the domino effect of multiplying fears regarding global growth estimates and ultimately of recession in the broader global economy.

Attached to these recessionary fears, there has been a further slump in oil and commodities prices over the past few days, as these asset classes are heavily linked to economic growth. From a monetary policy perspective, this is a plus as the price falls here are de-inflationary, giving central bankers a lot more interest flexibility than they had maybe six weeks ago.

Whilst the recent devaluation of the pound against all other major currencies has given the Bank of England further concern (in its fight against inflation) that price inflation would be imported to the UK, the current state of the UK economy across the board implies that the current monetary policy stance will lead to a further contraction of growth, potentially lengthening the recession we are now experiencing.

Whilst we were hoping that the Bank of England would move to provide some monetary policy stimulus in November this year at the earliest, we believe that the Monetary Policy Committee have enough flexibility to provide some stimulus this month, following the lead of the Australian Central Bank's 100 basis point cut within the last few hours.

### **MPL Asset Allocation**

#### *Cash*

In line with the unprecedented events of the last month, fixed term money market deposit rates have increased dramatically with deposit rates ranging from 4.947% per annum pro rata per annum (for one week deposits) up to 6.170% per annum for a 12 month fixed term deposit. It has become increasingly clear that whilst short term funding in the financial sector has dried up, the major problem here is not the major reduction in liquidity which has resulted, but rather the total lack of confidence that financial institutions continue to have in lending to each other.

We have continued to take advantage of current conditions, rolling 20% of client portfolios into 3 month UBS money market fixed term deposits. With this in mind, we think it is important to review some facts regarding UBS and their position in the current market environment.

UBS remains one of the best capitalized financial services firms in the world<sup>1</sup>. The fundamentals underlying the business remain strong, including:

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<sup>1</sup> Based on Tier 1 regulatory capital ratio at June 30, 2008

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- BIS Tier 1 capital ratio of 11.6% (as of June 30, 2008) – one of the best in the industry.
- Strong credit ratings of Aa2 (Moody's) and AA- (S&P and Fitch)

UBS addressed the turmoil in the markets early by strengthening its balance sheet through capital-raising and a successful rights offering, raising approximately USD 28 billion of new funds. The company's positions related to US sub-prime and Alt-A residential mortgages have been reduced by 75% to USD 13 billion<sup>2</sup>. Hence it is now in a better situation to hedge and manage the remaining exposures.

As a result of proactively addressing these issues early on, UBS are now capable of absorbing further shocks to the market.

#### *Fixed Income*

In the past three weeks we have sold our Gilt holdings across the various term ranges, as we have seen the short term one year gilt yield fall to 3.44%. With a market consensus that interest rates cuts will be seen over the next year down to a level between 3.75%-to-4.00%, we felt that the yield reduction in gilts is overdone and hence disposed of the holdings locking in a capital gain between 4-5% and a income coupon of 2-2.5% giving a total return between 6-7.5% in the period since purchase.

As per our previous letter to you, prices in the Gilt market are now back at the high levels seen last March. Having taken advantage of the misplaced view priced into the gilt market that inflation would continue to increase in the longer term looking forward, we now see that gilt valuations (which were already priced well over par) have been pushed even higher due to a lack of confidence in the bank deposit system forcing investors to seek the safety of the UK Government Treasury Stock, leading to what we believe is now an overvalued gilt market.

Generally, we would never invest in gilt holdings valued over par and hold them to maturity due to the capital loss which would be incurred at redemption (i.e., an investor purchasing gilts over par at, say, 105 pence would only receive 100 pence (*par*) at the point of redemption, losing 5 pence or 4.8% of capital invested).

Gilts have been recommended by market commentators as a safe haven in these conditions. A lot of investors have purchased very short dated (close to maturity) gilts recently. We must stress to investors who have done so that sentiment in global financial markets can change sharply. If this occurs in the gilt market, it will move very quickly to the detriment of investors who have purchased this overvalued asset class and hence these holdings need to be watched closely.

#### *Equity*

We have slightly increased equity levels (using index trackers for medium risk clients and above) to 45-50% of portfolio holdings as we believe that equities are attractively valued.

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<sup>2</sup> From December 31, 2007 to June 30, 2008

With the FTSE 100 index now priced at 9.56 times company earnings, yielding 5.00% compared with the UK Government 10 year gilt yield of 4.24%, a case must be made that fundamental factors in some (under-leveraged and well run) sectors of the equity market have been totally overlooked as investors' minds have been beset with panic regarding the financial sector.

We are happy to receive a decent dividend yield, being paid whilst we wait for co-ordinated government action to help restore confidence in financial markets; thus reducing the current level of panic inherent in these markets and allowing these overlooked fundamental factors to emerge (with the hindsight of the current economic climate, aided, we hope, by fiscal and monetary measures) and be focused upon once more, to the benefit of our clients.

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