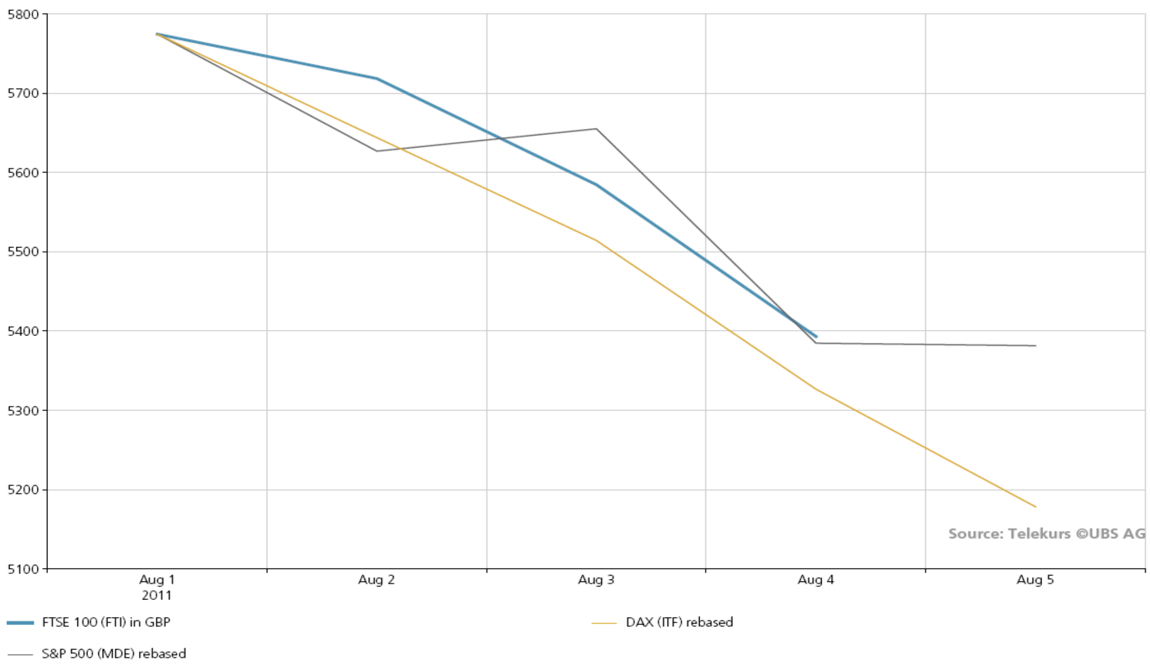
9th August 2011

Market Report

The events of the last week continue to highlight that not only does investor sentiment remain fragile, it is indeed wafer thin.

The chart below highlights a week in which equity markets experienced some of the sharpest falls seen since December 2008.

FTSE 100, the DAX and S&P 500
1st August – 5th August



The week began with investors focused upon stalling global economic growth, prompted by weak US manufacturing growth data, and the political deal to raise the US debt ceiling by $2.1 trillion in order to facilitate the payment of bond interest to the country's debt holders.

On Tuesday, bond yields in Italy and Spain approached 7 per cent (levels which are considered unsustainable), raising fears that the Italian and Spanish governments would be the latest to require a bail-out from the European Central Bank, as they would not be able to raise funds in the bond markets owing to the unsustainably high level of interest each country would have to pay on this debt going forward.

Comments made by Jose Manuel Barroso, head of the European Commission, regarding “a growing concern among investors about the systemic capacity of the euro area to respond to the evolving crisis”, prompted further uncertainty on Wednesday. Investor selling of risky assets, and subsequent purchase of safe haven assets and currencies, forced the Swiss National Bank to cut interest rates in response to the sharp rise in the Swiss Franc owing to its safe haven status.

The following day, the Japanese government were forced to intervene in the foreign exchange markets for similar reasons. With investors seeking the safety of the Yen, the Japanese currency rose to a record high against the dollar. In order to protect the Japanese exporters, the Japanese central bank spent ¥4,500bn flooding foreign exchange markets with Yen, forcing the value of the Yen to tumble against the dollar. With market falls in Europe managing to overshadow the action taken in Japan, Jean-Claude Trichet, European Central Bank President, said “the bank has resumed buying government bonds and offering loans to the region’s banks to relieve tensions in the euro zone financial markets”. This news offered only brief respite, as market participants expressed their disappointment that this action didn’t include Italian or Spanish debt, and markets continued to fall.

Friday saw the focus turn back towards stalling global economic growth and to the United States for the key US jobs numbers. Markets rallied when better than expected numbers for July were released by the US Bureau of Labor, which with upward revisions to the jobs numbers for May and June indicated an improving jobs situation (admittedly still within a very bleak period). This rally reversed as rumours began to surface after 2 pm US Eastern Standard Time that the ratings agency Standard and Poor’s were about to release a statement regarding a possible downgrade of the United States debt from AAA to AA+ for the first time in the country’s history. The statement was duly delivered on Friday evening with the ratings agency explaining that the downgrade was entirely political, reflecting the company’s view that the “effectiveness, stability and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges”. This in part is a direct criticism of the recent problems associated with the US congress agreement upon the US debt ceiling.

Positives and Negatives

Whilst the obvious short term market reaction to these events is negative, the longer term outlook has to be viewed as positive for a continued allocation to global financial markets for the following reasons, when considering global growth.

US Downgrade

Perversely the downgrade of debt for any entity, whether it is a company or country, should have a negative effect upon that entity’s equity, debt, currency etc. A downgrade should result in a higher rate of interest to borrow funds being paid, as investors would require a higher rate of return for investing in riskier assets. The US dollar is the major global reserve currency and investors have fled to the safety of US debt with the ultimate effect being a reduction in yield and an increase in price, with a negligible effect upon the rate at which the US government can borrow funds to meet its debts. The effect in the bond markets of this downgrade so far has been quite small and, if the US problems are addressed, this could result in US debt being backed by a stronger, more highly rated country in the longer term.

Investors were made aware that the S&P could potentially downgrade American debt back in April and this had a minor impact upon financial markets at that time. The latest announcement should not have come as much of a surprise and indeed should now give US politicians a sufficient kick up the backside to address their debt problems over the next few years. Hence this can only be viewed as a positive for the US economy over the longer term, as debt reduction will make the balance sheet of the country stronger and ultimately benefit its economy.

Market Movements

The following charts highlight the effects upon other financial markets resulting directly from the events of last week.

WTI Crude Oil – August 2010 - 2011

Source: Bloomberg

Crude oil has fallen 26% since early May with the benefits of this fall hopefully being felt by US consumers in the forthcoming months.

Copper - August 2010 - 2011

Source:Bloomberg

Copper, which is a very good indicator of global growth/demand, has risen rapidly since Ben Bernanke's Jackson Hole speech in August last year. The 3 month forward copper contract has fallen nearly $800 per ton in the last seven trading days. We believe that this fall reflects financial market sentiment rather than a worrying indicator of a severe fall off in global economic growth. We accept that the global economy will not grow as rapidly as it has done since March 2009; however, we believe that if the price fall seen here reflects a slowdown in economic growth; it has been vastly overdone.

The positive resulting from this fall is that many of the companies surveyed in the July US manufacturing data pointed to increased input/raw materials costs as a major squeeze upon their operating margins. In the shorter term, these enterprises should benefit from cheaper raw materials prices.

Fundamentally, the effects shown above should happen with the positive effects of these price falls being reported in many companies' quarterly results over the next two to three quarters. Annual earnings estimates for companies in many sectors had already been reduced in the weeks prior to these events unfolding. Hence, the fundamental effects of the price falls witnessed in the past week could have a very positive effect upon economic, consumer and company data globally as we move forward through the third and fourth quarters of 2011 and could lead to earnings surprises in some cases.

MPL Asset Allocation

With this in mind, in order to take advantage of this opportunity presented above, we have increased our exposure to the US equity and global technology markets. However, we are wary of the fact that, whilst we believe in the fundamental case for this investment, at times investor emotion (or panic) completely ignores rational thought and we accept the significant level of risk which is attached to this investment case at this point in time, and will act swiftly if these assumptions are proved to be incorrect.

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