

## Summary

- **US economic growth continues to slow but growth appears robust in UK and Europe.**
- **Inflation signals are mixed, despite a fall in the oil price. Interest rates stable in US but due to rise in UK and Europe.**
- **Energy and Mining outperformed in October as oil prices stabilised and metals prices hit new highs.**
- **Equity valuations now more expensive vs bonds and corporate earnings growth is eroding.**

## Mixed Signals in the Global Economy

US retail spending remained firm in October, supported by the recent fall in oil prices. The big surprise for the month, though, was third quarter US economic growth of only 1.6%, well below the expectations of 2.2%. Employment growth was also weak, demonstrating that the slowdown in the housing market is having implications more generally for growth in the US. Despite this, core US inflation (excluding energy) remains well above the Federal Reserve's implicit 1 - 2% target at 2.4%. With this level of inflation, there is little prospect of a cut in short term interest rates in the near term. 10 year US bond yields were little changed over the month, despite the gloomy economic data, pointing to concerns that inflation may be more persistent than is desirable.

In the UK, by contrast, gross domestic product growth has been revised upwards and is now expected to be 2.6% in 2006. Inflation is also higher than expected, at 2.5% and is rising despite the fall in energy prices. The result is that the Bank of England is most likely to raise interest rates by 0.25% to 5.00% this month and this has helped sterling appreciate against all the major currencies. As in the US, bond yields were unchanged over the month, as investors place faith in the Bank to keep inflation under control. With the housing market showing renewed strength and a rise in consumer net income as energy prices fall, this faith may be tested in coming months. Hence our UK bond portfolio is positioned in relatively short maturity bonds.

In the Eurozone, inflation was below the European Central Bank's target for the second month. However, high money supply growth and business and consumer confidence at five year highs will justify a rise in interest rates in December.

The Japanese economy has shown signs of sustainable growth in recent months and this has prompted the Bank of Japan to end their zero interest rate policy. However, with

prospects of the US economy slowing and the uncertainty created by the appointment of a new Prime Minister, there is little chance of interest rates rising further in the near term. The economic uncertainty was reflected in a weak equity market performance over the month and points to a further weakening of the yen against sterling.

## Total Returns in Local Currency

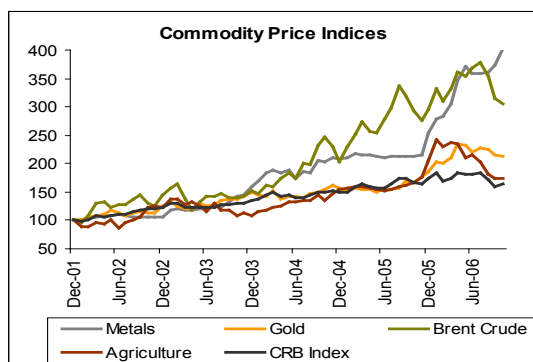
*Last month and last 12 months*

		Total Return	
		1 month to 31 <sup>st</sup> Oct %	12 months to 31 <sup>st</sup> Oct %
Currencies v £	Rate		
US dollar	1.90	-1.8	-6.9
Euro	1.49	-1.1	-0.9
Yen	222	-0.8	-7.4
Cash (3m)	Yield %		
USA	5.27	0.5	4.1
UK	5.11	0.4	4.4
Euro	3.52	0.3	2.2
Japan	0.37	0.0	0.0
Bonds (10yr)	Yield %		
USA	4.60	0.8	4.3
UK	4.52	0.5	2.9
Germany	3.74	0.0	0.6
Japan	1.73	-0.3	0.1
Equities	Index		
USA	S&P Comp	3.3	16.6
UK	FTSE 100	2.9	19.2
Germany	DAX	4.6	29.4
France	CAC	2.1	23.5
Spain	SMSI	6.6	35.1
Italy	BCI Gen	3.4	24.2
Japan	Topix	0.5	13.0
Australia	All Ord	5.0	25.2
Hong Kong	Hang Seng	4.7	30.7
Alternatives	Index		
Property	IPD	1.3	20.7
Commodities	DJ AIG	4.7	4.9
Hedge Funds	HFR	2.0	9.3

# November 2006

## Equity Markets Respond Positively to Lower Energy Prices

Our overweighting in equities benefited clients' portfolio returns, as UK and global equities outperformed UK bonds in October, helped by stabilisation of energy prices and



generally healthy corporate earnings reports. After the 25% crude oil price decline during August and September, markets were relieved to see Brent crude settle around \$60/barrel. Metals, however, rose during October after six months of stability.

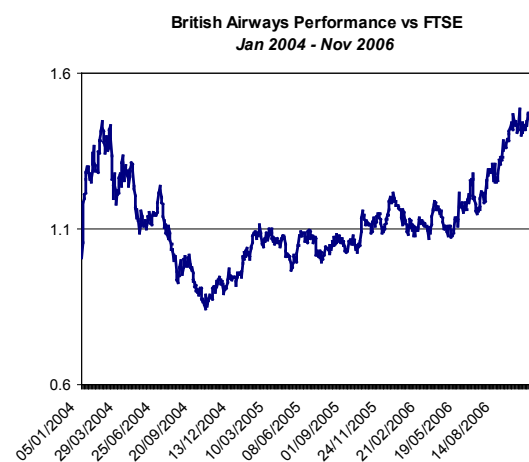
In the UK, the Mining and Metals sectors outperformed, recovering from their recent weakness and suggesting that investors do not anticipate the current US slowdown to turn into a global recession. Other sectors that performed well were Aerospace, Telecoms, Food and Drugs Retailers and Non-life Insurance. We are wary of Aerospace and Defence, given the dependence of BAE Systems and other UK stocks in the sector on US defence spending. This is likely to be curtailed if the Democrats win control of Congress in the November mid-term elections, as seems most likely.

Telecoms performed well, with BT continuing to outperform the market (now up by 33% since May) and Vodafone coming back into favour on hopes that a combination of cost cutting and developing market mobile phone growth will lead to an upgrading in earnings expectations. In the insurance sector Catlin Group has performed well and was in the headlines with a proposed merger with Wellington, another Lloyds insurance company. This will give Catlin greater exposure to the

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US insurance market and has been well received in the market place.

Our holding in Tesco has continued to perform well, with overseas earnings forecasts being raised. The shares are starting to look expensive however, and are now on our watch list. Another of our holdings that is ready for profit-taking is British Airways. The stock has outperformed the market by 28% since May and is now threatened with a pilots strike. More significantly, the slowdown in US economic growth may well lead to a fall in passenger numbers and compromise the ability to pass on higher costs, specifically security and fuel surcharges.



We have decided to hold on to Land Securities, which although expensive on a price to earnings basis, is reasonably valued on price to book value, a more appropriate measure for an asset, as opposed to an income, based business. Anticipation of conversion to a high yielding Real Estate Investment Trust early in 2007 should maintain the upward momentum for Land Securities for a little while yet.

## Hedge Fund up 3.0% in October

Our selected hedge fund, the Valu-Trac Strategic fund, benefited from a 25% rise in the price of corn over the month and from a strong Hong Kong equity market.



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