



## Summary

- **Inflation higher than expected in the UK, leading to a surprise rise in interest rates. More to come.**
- **US economic growth accelerating as the housing market stabilises.**
- **Bond prices have fallen over the month and the dollar has recovered from its lows against sterling.**
- **Equities respond well to the improved growth outlook.**

## Inflation concerns rise

January has seen a shift in the outlook for economic growth and inflation in the UK and the US. In the UK, the announcement of retail price inflation at 4.4%, accompanied by the surprise decision of the Bank of England to increase interest rates by 0.25% to 5.25%, has raised the spectre of a wage / price spiral in the making. This is at odds with previous expectations that lower energy prices will lead to a fall in inflation, back to the Treasury's target of 2%, by the end of this year. Whilst the events of one month do not necessarily change the outlook for the year, the wage negotiations of the next two months will be watched with unusual interest. This was enough to worry the bond market and during January 10 year UK government bond yields moved up in line with short term interest rates to produce a negative return of -1.5% for the month.

In the US, the markets have been expecting that a weak housing market would produce slower growth and possibly prompt a cut in interest rates in the first quarter. However, fourth quarter economic growth was better than anticipated, up 3.5% at an annual rate, and unemployment fell to 4.5% in January, well below the perceived equilibrium rate. There was also evidence that the housing market may be stabilising, so hopes of an early cut in US interest rates have been shelved for the time being, pushing US bond yields up and raising similar concerns over inflation as we are seeing in the UK.

## More rate rises in prospect

In the UK and the US corporate profitability is at a high point for this cycle and it is only the threat of outsourcing and immigration that is keeping wage demands in check. However, wages in the developing economies are rising at a 10% annual rate and so, with unemployment low in the UK and US, the risks are increasing that wage demands and inflation will rise further. In the last month we saw

average UK wage growth rise to 3.5% compared to 3.0% in the previous month, a worrying trend even though the absolute level is still relatively low. With the credibility of the Bank of England at stake, there is a possibility the Bank will put up interest rates again in February, though a move in March is more likely. Bond yields may rise a little further

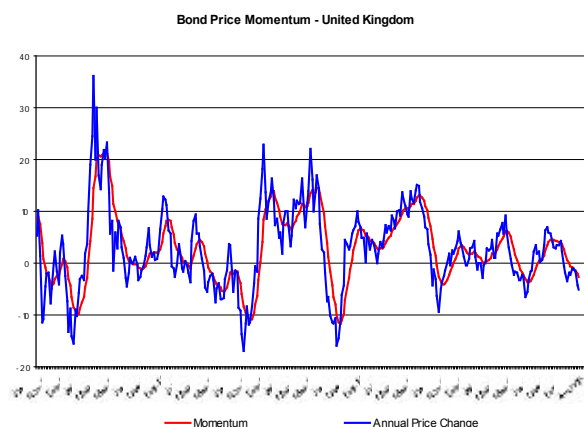
## Total Returns in Local Currency

*Last month and last 12 months*

		Total Return for Market	
		1 month to 31 Jan %	12 months to 31 Jan %
Currencies v £	Rate		
US dollar	1.96	-0.2	-9.4
Euro	1.51	-2.0	-3.3
Yen	239	-2.3	-12.6
Cash (3m)	Yield %		
USA	5.30	0.5	4.7
UK	5.49	0.5	4.6
Euro	3.73	0.3	2.5
Japan	0.41	0.0	0.0
Bonds (10yr)	Yield %		
USA	4.88	-0.9	2.1
UK	4.99	-1.5	-2.3
Germany	4.10	-0.8	-1.5
Japan	1.71	0.0	0.4
Equities	Index		
USA	S&P Comp	1.6	14.1
UK	FTSE 100	-0.3	11.3
Germany	DAX	3.1	21.8
France	CAC	1.4	15.6
Spain	SMSI	3.9	37.2
Italy	BCI Gen	1.7	17.6
Japan	Topix	2.5	1.5
Australia	All Ord	2.4	23.0
Hong Kong	Hang Seng	1.0	31.1
Alternatives	Index		
Property	IPD	1.5	18.7
Commodities	DJ AIG	0.2	0.4
Hedge Funds	HFR	1.3	7.2

# February 2007

until it is apparent that house price and wage inflation are under control. Bond price momentum is still falling, as can be seen in the chart, pointing to the risk of further declines in prices. At some point, though, this will present the opportunity to lengthen the maturity of our bond portfolio in anticipation of a reversal in this trend. We still expect bond yields to end the year below current levels, producing capital gains, as inflation falls in response to the higher level of interest rates.



Source: Valu-Trac

## Equities driven by takeovers

Equity markets around the world generally produced positive returns last month as the improved growth prospects outweighed the rise in interest rates. Sterling appreciated against all the major currencies, but international stock markets still produced positive returns in sterling terms. In the UK, the market was little changed on the month as a spate of takeover rumours compensated for higher interest rates. The prices of Sainsbury, Smith and Nephew and Corus, the steel company, all benefited from takeover activity. It appears that private equity groups are now turning their attention to larger companies, testimony to the perception that current levels of corporate profitability are sustainable and pricing power is returning to many sectors.

## Energy and metals prices rise

Energy and metals prices reversed some of their falls, with oil up from a recent low of \$50 per barrel to \$56 at the month end. Copper prices, having fallen 17% from their peak, look set to turn as inventories hit a low point

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and supply constraints remain in place. We therefore took profits on our holding of Dairy Crest, which had outperformed the FTSE 100 by 35% since we first bought the stock and reinvested in the mining company, Xstrata, which has a high exposure to copper. We are now over-weighted in the mining sector, where valuations are now extremely low in spite of continuing upgrades to earnings expectations.

The other sector where we are over-weighted is pharmaceuticals. Having suffered from the appreciation in sterling over the past year, UK companies such as Glaxo and Astra-Zeneca are cheap. Investors are now beginning to recognise not only the attractive valuation of these companies, but also their lack of gearing and therefore insensitivity to interest rate changes - beneficial in the current environment. Additionally, with US economic growth better than expected and interest rate cuts off the agenda, the US dollar has stopped falling against sterling. With a high proportion of UK pharma earnings coming from the US, a stronger dollar produces higher earnings in sterling terms. The result has been a strong rebound in the pharma sector over the past month.

## Outlook still favourable for equities

The positive outlook for growth in 2007, along with energy prices that are still 20% below the levels of a year ago, is supportive of equity markets. Nevertheless, valuations of the developed markets, whilst well below the levels of the bubble era, are not cheap and if bond yields rise too far they will start to undermine the relative attractiveness of equities. Already, the intrinsic value yield on US equities has fallen below the bond yield, pointing to relative underperformance from US equities. We remain overweight in Pacific Basin equity markets, which continue to perform strongly and in Europe, where the productivity improvements continue as unemployment falls to new lows for this cycle.

**Matthew Hunt**



**PROSPECT**  
WEALTH MANAGEMENT

22 Rathbone Street, London W1T 1LA  
T: +44 (0)20 7413 2799 F: +44 (0)20 7413 0988  
[www.prospectwealth.co.uk](http://www.prospectwealth.co.uk)