

Summary

- **Equity market sell-off contained by sound underlying fundamentals.**
- **Bond markets have rallied on hopes that economic growth will slow and inflation fall.**
- **Alternative investments have performed well in the recent equity weakness.**
- **Prospect portfolios have outperformed, highlighting the resilience of undervalued stocks.**

Setback for equities

The month was going well for global equities until February 27, when the Chinese government cracked down on illegal investments and speculation. This knocked the Chinese equity market down by 9% in a single day. Although this was less than the market had risen in the previous week and little by comparison with the 130% rise of the past 12 months, it coincided with news of a surge in US subprime mortgage defaults and a comment from the previous governor of the US Federal Reserve Bank that there was a risk of recession in the US.

The result was a bout of profit taking, which spread to other markets as investors began to worry that the rise in Japanese interest rates of a few days earlier might cause the yen to appreciate. The fear was that those who had borrowed money at low interest rates in yen to buy assets in other markets might be forced to sell these assets to buy back their yen. Expectations of further interest rate rises in the UK and Europe added to the uncertainty and by March 5th global equity markets had corrected by an average of 5%.

After a prolonged period of low volatility and rising equity prices, it is not surprising that there was a fall in equity markets. Too much stability encourages risk taking and regular corrections are healthy in that they discourage the excessive exuberance that leads to full blown crashes.

Fundamentals remain supportive

However, the fundamentals for equity markets do not point to a sustained decline in prices. Most importantly, company profits are expected to rise by 5 to 10% this year in all the major markets and the latest company reports have generally beaten expectations by a considerable margin in the US, UK and Europe. This growth is supported by rising productivity,

thanks to the globalisation phenomenon and low real interest rates, factors that are unlikely to change in the short term. The problems in the US debt market appear to be contained within one sector and there are signs that the worst may already be over for housing. There is no evidence at present that the US housing slowdown is unduly impacting the wider

Total Returns in Local Currency

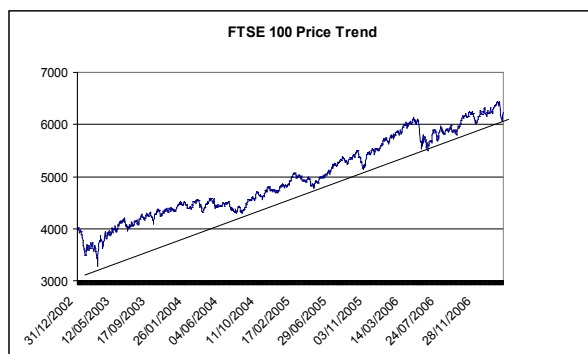
Last month and last 12 months

		Total Return for Market	
		1 month to 28 Feb %	12 months to 28 Feb %
Currencies v £	Rate		
US dollar	1.96	-0.1	-10.7
Euro	1.48	2.0	-0.8
Yen	233	2.6	-12.7
Cash (3m)	Yield %		
USA	5.27	0.4	4.8
UK	5.45	0.4	4.5
Euro	3.79	0.3	2.6
Japan	0.64	0.0	0.0
Bonds (10yr)	Yield %		
USA	4.58	2.7	4.5
UK	4.80	1.9	-0.5
Germany	3.96	1.4	-0.3
Japan	1.64	0.8	1.2
Equities	Index		
USA	S&P Comp	-2.2	11.6
UK	FTSE 100	-0.2	10.1
Germany	DAX	-0.9	18.2
France	CAC	-1.4	12.8
Spain	SMSI	-1.7	27.1
Italy	BCI Gen	-2.2	12.3
Japan	Topix	1.9	6.5
Australia	All Ord	1.4	24.2
Hong Kong	Hang Seng	-2.0	26.9
Alternatives	Index		
Property	IPD	0.7	16.9
Commodities	DJ AIG	3.4	10.7
Hedge Funds	HFR	-0.9	6.9

March 2007

economy, with consumer spending rising by 3.5% in the year to January.

Equity valuations, using our preferred measure of cash flow yield, remain expensive in the US, but in the UK, Europe and Japan are half-way between fair value and expensive. In the benign economic environment we are enjoying at the present time, such valuations appear to be sustainable for a while longer. As the chart below shows, the upward trend in UK equities remains in place.



Bond markets benefit

The equity market sell-off was accompanied by a fall in bond yields, producing a 1.9% gain over the month for UK bond investors. This points to expectations that growth and inflation will slow, though with short term interest rates 0.65% above 10 year government bond yields, the scope for bonds to rally further in the short term appears limited. For some time, the yield advantage that corporate bonds have had over gilts has been at historic lows. Not surprisingly, jitters over the economic outlook caused a sell-off in low quality bonds, but this benefited the A rated investment grade bonds in our portfolios as investors switched into safer, high quality bond issues.

Whether or not UK interest rates will be raised in April, as the market is anticipating, will be determined by the progress of the current wage round. So far, wage demands have been muted, though it remains to be seen whether Gordon Brown will be able to make his proposed 1.9% wage rise stick in the public sector.

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Diversification is key

Once again we have seen in this correction that diversification across asset classes, as well as across equity markets, is key to limiting short term losses. Bonds were not the only asset class to do well over the past month. Commercial property returns, though slowing, were still positive in February. Commodity prices overall were up by 3.4% over the month and our commodity fund outperformed by 2%. Hedge funds were down on average, but our Valu-Trac Strategic fund was up by 3.3% thanks to an overweighting in bond markets.

UK equity portfolios outperform

Our core UK equity portfolio has performed well during the recent correction as holdings in the defensive pharmaceutical and utility sectors outperformed and offset temporary weakness in mining, where we are overweight. Recent strong results from Xstrata, the diversified mining company, highlight the attractive potential of the mining sector, where shares are now on very attractive valuations due to a continued positive outlook for earnings growth. The Alpha portfolio, our focused UK equity model, is substantially overweight in mining and is thus well positioned to take advantage of a recovery in this sector. The portfolio has outperformed strongly during the downturn, reinforcing our view that undervalued stocks perform well in times of uncertainty.

Another theme of recent weeks has been the outperformance of interest rate sensitive stocks. It is no surprise that the Bank of England has not raised interest rates this month in view of recent equity market volatility. This has benefited Persimmon and Speedy Hire, both involved in the building sector and sensitive to the outlook for housing.

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