

Summary

- **US mortgage market sell-off causes a flight to safety, benefitting UK government bonds.**
- **Corporate bond yields have risen as hedge funds sell to cover losses on US mortgage bonds.**
- **European and US equity markets correct as the cost of corporate borrowing rises. Valuations remain supportive of equities though .**
- **Property funds experience net redemptions but office property sector remains strong.**

Credit crunch fears create volatility

The stronger growth that we have seen in the major economies in recent months has raised inflation expectations and led to higher interest rates and bond yields. The knock-on from this has been a sharp rise in mortgage defaults in the **US** amongst low quality borrowers. Although the size of this “sub-prime” market is not large in the context of the total US mortgage market, losses in this sector have rippled through the financial system, causing yields on higher quality bonds to rise sharply over the past month. As the cost of borrowing has risen, so the ability of private equity to undertake leveraged takeovers has diminished, potentially spelling the end of the takeover boom of the past 18 months.

The effect has also been felt in Europe, as one **German** bank had to be rescued in July, after taking excessive exposure to US sub-prime mortgage debt. This appears to have been an isolated case, but it has nevertheless made investors nervous. In the **UK**, although there is no evidence of problems in the mortgage market, hedge funds with exposure to US mortgages have been forced to sell better quality bonds to cover US losses. As a result, corporate bond yields rose by 0.3% relative to government bonds over the month. This, combined with the rise over the past four months in government bond yields was enough to unsettle the UK equity market, which fell by 3.7% over the month on concerns that higher rates would lead to a slowdown in growth and profitability.

Government bonds a safe haven

The combination of a flight to quality and the potential for slower growth meant that 10 year UK government bond yields fell from 5.5% to 5.2%, producing a total return of 2.1% for the month. Looking forward, the economic slowdown and lower inflation that would support a continued fall in bond yields is not in evidence at present. On the contrary,

overall economic growth in the second quarter was well above trend at 3.0% year on year and the latest industrial production data and industry surveys point to this growth continuing. Unemployment fell to 5.4% in June and retail sales continue to be strong in spite of the rises in interest rates and a low savings ratio.

Total Returns in Local Currency

Last month and last 12 months

		Total Return for Market	
		1 month to 31 July %	12 months to 31 July %
Currencies v £	Rate		
US dollar	2.03	-1.0	-8.1
Euro	1.48	0.0	-1.5
Yen	240	3.0	-11.0
Cash (3m)	Yield %		
USA	5.30	0.5	5.5
UK	5.96	0.5	4.7
Euro	4.21	0.4	3.2
Japan	0.72	0.1	0.3
Bonds (10yr)	Yield %		
USA	4.73	2.7	7.1
UK	5.25	2.1	-0.3
Germany	4.32	2.3	0.8
Japan	1.80	0.8	3.2
Equities	Index		
USA	S&P Comp	-3.0	15.8
UK	FTSE 100	-3.7	10.9
Germany	DAX	-5.1	35.8
France	CAC	-4.8	17.6
Spain	SMSI	-0.3	30.1
Italy	BCI Gen	-3.7	14.7
Japan	Topix	-3.8	9.6
Australia	All Ord	2.2	29.9
Hong Kong	Hang Seng	6.7	40.1
Alternatives	Index		
Property	IPD	0.7	11.7
Commodities	DJ AIG	1.5	1.2
Hedge Funds	HFR	-1.8	14.0

Source: Reuters

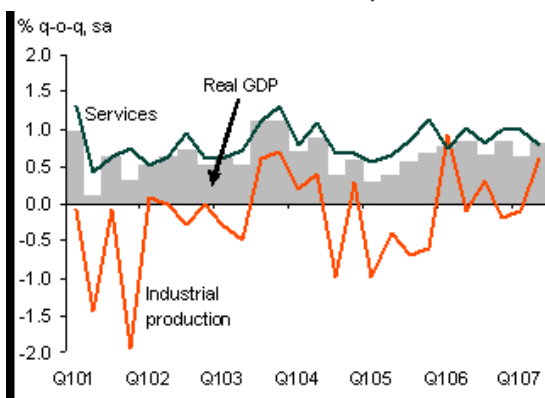
August 2007

The great unknown is how the consumer will react as recent interest rate rises feed through into mortgage rates. House repossessions have risen sharply, but other indicators of property trends point to a gradual slowdown in price appreciation rather than a rapid decline. With oil prices back up to \$77 per barrel, food prices rising on weather related shortages and some evidence of wages creeping up from the 3.5% growth rate we have

in its balancing act of bringing down inflation without stifling the economy, this is not the time to sell out of equities.

The bond market gyrations have had less impact on Asian equities (where we are overweight) and it is notable that Hong Kong equities rose by 7% over the past month. Asian growth is becoming increasingly self-sustaining and the region is now a huge source of liquidity for global markets, providing an additional underpinning to equities.

UK Economic Activity



Source: Lehman Brothers

seen in recent months, it is still likely that we will see another interest rate rise to 6.0% this year. The risks are increasing that the progress towards lower inflation will be slower than we had expected and we have therefore reduced our bond exposure through the sale of the Royal Bank of Scotland 6.2% 2020 and reinvested in the 2014 Treasury stock. This has the added attraction of reducing credit risk at this time of uncertainty.

Property

For the first time in several years, investor withdrawals exceeded inflows for the major property trusts in the month of June. As a result, the funds, including the largest, the Norwich Property trust that we hold in our alternative investment portfolio, moved the pricing of the fund to a bid basis resulting in a one-off 5% price decline. Prices of commercial property overall continue to rise, with the IPD property index up 0.7% in the month of June, as a strong office market offset a weak retail sector. Whilst the froth has gone out of the market, there is no sign of a significant price decline.

Matthew Hunt

Principal

Equity valuations not stretched

Robust economic growth should be positive for equities, providing market valuations are not expensive. As our chart shows, the sell-off in the past month has raised the cash-flow yield on UK equities back into the comfort zone, though they are still not cheap on this measure. Company earnings growth has been revised up to 8% year on year, however, placing the market on a prospective price earnings ratio of only 12.9 times, which compares favourably with the long term average of 13.5. On the basis that the Bank of England succeeds

Equity Cash Flow Yield - United Kingdom
to 31 July 2007



Source: Value-Trac

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