

## Summary

- **Government bond markets continue to rally, equity markets broadly unchanged in August.**
- **Economic news generally favourable, though US unemployment disappointed.**
- **Corporate bonds fail to participate in bond rally, presenting potentially attractive opportunities.**
- **Company earnings growth remains robust and should underpin equity markets.**

## Central Banks soothe markets

The turmoil in financial markets that started in July appears to have subsided from its peak, reached in mid-August. The source of the problems, namely an increase in defaults on sub-prime mortgages in the US, should not of itself have caused the market volatility we have seen. It is the widespread uncertainty as to which financial institutions hold these complex assets and how these devalued securities should now be priced that has caused the stress. The result has been a reluctance on the part of banks to lend to any financial organisation, including each other, paralysing the monetary system in the process. The central banks have, meanwhile, fulfilled their role as lenders of last resort, thereby supporting the banking system and allowing some semblance of calm to be restored.

As the table on this page shows, equity market moves from the beginning to the end of August were actually quite modest (with the exception of Japan) and bond market returns were strongly positive. These returns reflect the generally favourable news on the major economies announced during this period.

## Global economic resilience

In the **US**, even the worst affected part of the economy, housing construction, has only reduced overall US growth by 0.75% over the past 18 months. To put events in the mortgage markets in perspective, delinquencies in variable rate sub-prime mortgages have reached a high of 13% but *fixed rate* sub-prime delinquencies have been stable at 5%. Moreover, delinquencies on fixed rate *prime* mortgages, which represent the bulk of outstanding mortgages, have been stable at less than 1%. Thus, although the stock of unsold homes is high, which spells more hardship for the construction sector, the US housing market is not collapsing. Of more significance is employment. The graph overleaf

shows the close relationship between unemployment claims and retail sales. It also shows that US unemployment claims remain relatively low, even during August. The latest monthly employment data were not so encouraging, however, and this is likely to encourage the Federal Reserve to cut interest rates in mid-September.

## Total Returns in Local Currency

*Last month and last 12 months*

		Total Return for Market	
		1 month to 31 Aug %	12 months to 31 Aug %
Currencies v £	Rate		
US dollar	2.02	0.7	-5.5
Euro	1.48	0.3	0.6
Yen	233	2.9	-4.2
Cash (3m)	Yield %		
USA	5.58	0.5	5.4
UK	6.53	0.5	4.9
Euro	4.66	0.4	3.3
Japan	0.90	0.1	0.3
Bonds (10yr)	Yield %		
USA	4.53	2.0	6.4
UK	5.04	2.0	0.5
Germany	4.25	0.9	-0.2
Japan	1.61	1.9	1.8
Equities	Index		
USA	S&P Comp	1.5	14.8
UK	FTSE 100	-0.2	10.3
Germany	DAX	0.9	32.9
France	CAC	-1.3	12.3
Spain	SMSI	-2.0	23.8
Italy	BCI Gen	-0.1	10.4
Japan	Topix	-5.6	1.8
Australia	All Ord	1.4	28.1
Hong Kong	Hang Seng	3.7	41.3
Alternatives	Index		
Property	IPD	0.2	10.1
Commodities	DJ AIG	-3.1	1.8
Hedge Funds	HFR	-4.1	8.5

Source: Reuters

# September 2007

In the **UK**, manufacturing output hit a 3 year high in August, thanks to strong demand from Europe, and corporate capital investment remains strong. In August, 42% of retailers reported increased sales volumes against 26% reporting lower sales. The net balance was unchanged on the previous two months. Clearly, the consumer has not been affected by the financial turbulence to date.

and is likely to produce attractive buying opportunities.

## Strong company earnings growth

The fall in bond yields has made equity valuations relatively more attractive. As we demonstrated last month, UK equity cash flow yield, a key measure of valuation, is within the range of fair value, though not cheap. So far, equity investors have taken the view that the liquidity crunch will have little effect on the real economy and to the extent that it does, the central banks will cut interest rates to maintain the health of the consumer and the corporate sector.

### US: low unemployment claims lead to strong sales



Source: U.S. Department of Labor, U.S. Census Bureau  
Note: Core excludes motor vehicles, gas stations and building material and supply stores

This is supported by the rapid pace of corporate earnings growth. European earnings grew by 15% in the year to June 2007, Japanese by 12%, Pacific Basin and the US by 9% and UK earnings by 6%. There is thus considerable momentum behind corporate earnings and there is little sign of any slowdown in Asia. Whilst a major reversal can never be ruled out, it looks unlikely at present.

## Bonds outperform...for now

Although the UK economic news has been encouraging, it would not be surprising to see a modest economic slowdown in the last quarter of 2007. This partly explains why government bond markets have performed so well over the past two months. The other reason is that UK consumer price inflation fell to 1.8% in August, within the Bank of England's target range and well below the 3.1% level seen in March. However, it is significant that not only the Bank of England, but also other central banks, have not cut interest rates in response to the market turmoil. Concerns remain that future inflation may not be so well-behaved, as commodity prices remain high and unemployment is falling. For this reason, we have kept our bond exposure at the shorter end of the maturity spectrum in the expectation that yields will rise again.

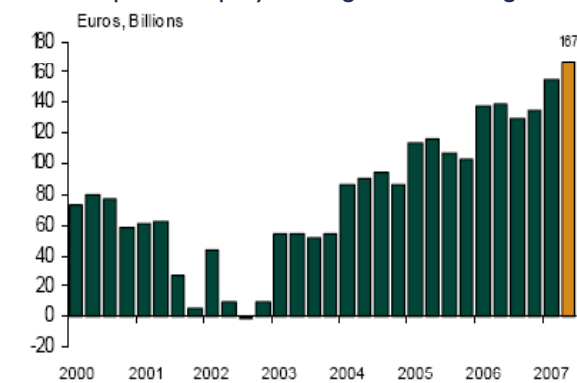
As a result, we are using current conditions to look for attractive buying opportunities rather than a time to sell.

**Matthew Hunt**

**Principal**

Whilst government bonds have performed strongly, corporate bonds have not participated to the same extent. Even though the bonds we hold are highly rated and the underlying companies are not affected by the liquidity crisis, all corporate bonds have suffered from a flight to treasuries. We expect this to be temporary

### European company earnings continue to grow



Source: Lehman Brothers

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