



## Summary

- **US rate reduction leads to gains for bond and equity markets in October.**
- **US growth in Q3 buoyed by exports and retail spending, despite housing recession.**
- **Equity sector performance highly divergent - new opportunities are appearing.**
- **Weak US dollar plus economic growth pushes commodities to new highs.**

## Rate Cut Supports Bonds & Equities

Recent headlines have been dominated by the woes of the banking sector in the US and UK, with several prominent bank executives paying for additional write-downs on mortgage-related loans with their jobs. Behind this has been a decline in US property prices, which are now forecast to fall by 7% over the next 12 months, further weakness in construction and worries over the possibility of widespread credit downgrades in the bond markets.

As a result, the US Federal Reserve cut interest rates again at the end of October, so 3 month interest rates are now 4.8%, half a percent lower than they were before the liquidity crisis struck in August. The immediate effect has been to weaken the dollar, which has hit new lows against sterling and the euro. Despite this, other asset classes have produced positive returns over the past month, as we show in the table opposite.

The reason for these positive returns is that the economic news has been reassuring. In the US, the October unemployment rate was unchanged at only 4.7% whilst job creation was stronger than expected. Consumer confidence has weakened, but retail sales and manufacturing output were still strong enough to produce robust growth in the economy of 3.9% during the third quarter, well above the trend rate of 2.5%.

A healthy rate of growth at a time when oil prices are close to \$100 a barrel and agricultural prices have risen sharply (the wheat price doubled between March and September, though it is now 17% off its peak) clearly raises the risk of higher inflation. Indeed, in October US inflation jumped to 2.8% from 1.9% a month earlier. It is not surprising therefore, that the Federal Reserve has indicated that there will be no further cuts in interest rates unless the economic data warrant it.

## UK Inflation on Target

Inflation in the UK, by contrast, has been stable at 1.8%, partly because the Bank of England has kept interest rates higher for longer compared to the US and Europe. As a result, economic activity does appear to be slowing, but no

## Total Returns in Local Currency

*Last month and last 12 months*

		Total Return for Market	
		1 month to 31 Oct %	12 months to 31 Oct %
Currencies v £	Rate		
US dollar	2.08	-1.7	-8.6
Euro	1.44	-0.2	3.7
Yen	240	-2.1	-7.3
Cash (3m)	Yield %		
USA	4.81	0.5	5.3
UK	6.15	0.6	5.2
Euro	4.45	0.4	3.6
Japan	0.82	0.1	0.4
Bonds (10yr)	Yield %		
USA	4.47	1.4	5.7
UK	5.00	0.8	0.9
Germany	4.29	0.8	-0.6
Japan	1.61	0.8	2.8
Equities	Index		
USA	S&P Comp	1.7	14.2
UK	FTSE 100	4.1	13.5
Germany	DAX	2.2	30.0
France	CAC	2.6	11.9
Spain	SMSI	8.0	17.8
Italy	BCI Gen	1.8	7.4
Japan	Topix	0.3	1.3
Australia	All Ord	3.4	31.5
Hong Kong	Hang Seng	15.7	74.2
Alternatives	Index		
Property	IPD	-1.2	4.9
Commodities	DJ AIG	3.3	15.4
Hedge Funds	HFR	3.9	12.8

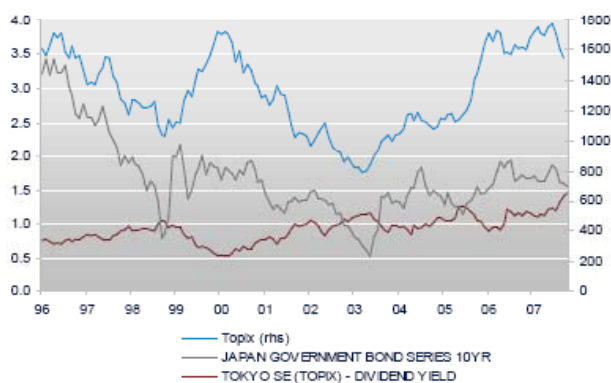
Source: Reuters

# November 2007

more so than the Bank needs to keep inflation below its 2.0% target. Retail sales have slowed, but are still growing at a healthy 3.0% and the latest wage data show personal earnings growing at 5.0% per annum. This points to the Bank leaving interest rates unchanged, probably until February next year.

This has reassured the UK bond market and yields on 10 year bonds have fallen over the past month, producing capital gains. The expectation is that a slowing economy will offset the inflationary pressures of higher commodity prices and higher wages. We still take the view that the risk is that the economy will remain stronger for longer, creating greater inflation risk and therefore we are maintaining our bond holdings in short dated maturities.

#### Japanese Equities: Poised for a Rally



Source: Goldman Sachs Research

## Equity Sectors Polarised

Equities continue to be supported by positive earnings growth, though the results are polarised according to market sector. For example, third quarter earnings for the US top 500 companies were down by 1% overall. Leaving out house building and financial companies, however, earnings were up 13%. Over the past month, overall earnings expectations for US equities are little changed.

In the UK, mining stocks have performed exceptionally well whilst the banks and property companies have fallen to valuations that discount declines in earnings of between 25% and 50%. Such a decline looks improbable unless the economy falls into recession. At present we

are overweight the mining sector and underweight banks and the opportunity to take profits and reverse this relationship is becoming increasingly attractive. As new leadership takes over at the large US banks, it is likely they will write off all the bad loans in order to start with a clean slate. This could well be the catalyst for recovery in the banking sector.

During October we reduced our overweighting in Pacific Basin equities in favour of Japan. Although Hong Kong was again the best performing market over the month and Japan was lacklustre, Pacific Basin equities appear greatly overvalued and vulnerable to correction. Japan, by contrast, offers better value and, with the dividend yield now matching the bond yield (see chart opposite), is well positioned for a rally, given historic experience.

## Commodities Make Further Gains

Strong commodity performance (see chart below) partly reflects the weakness of the dollar but, more importantly, the growth fundamentals of the global economy. Whilst we are constantly watchful for signs that a material economic slowdown is approaching, the evidence at the moment points towards modest weakness. This is good for bonds and good for equities, given that valuations outside the Pacific Basin are not overstretched.

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DJ AIG Commodity Index  
January 2005 - November 2007



Source: Reuters



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