PROSPECT
WEALTH MANAGEMENT

Investment Prospects

Summary

- **Bank of England cuts interest rates by 0.25% to 5.5% in response to liquidity squeeze.**
- **Rising inflation seen as less of a risk than a consumer led downturn.**
- **Shares exposed to the consumer cycle have over-reacted - the economic news has been reassuring.**
- **Commercial property valuations are being revised down. Risks are of a substantial correction.**

Fear Grips Markets Again

Despite the recent interest rate cuts in the US, which went some way to restore bond and equity market confidence in October, a series of additional bank write-offs and falls in property prices produced a further liquidity squeeze in November. Concerns are now focused on the extent to which liabilities that banks have distributed to third parties will end up back on the banks' balance sheets as guarantees are invoked. As in August, the scale of the problem is ill-defined and this uncertainty has caused banks to hoard cash, again driving up short term interest rates. In the UK, 3 month interest rates rose to 6.5%, 0.75% above the official bank rate.

US and UK equity markets in particular suffered from this combination of deteriorating housing markets and stubbornly high interest rates. Although the economic data has generally been better than expected, pessimism has grown that the indebted consumer will not keep spending in the face of falling house prices and rising mortgage costs. There is also the fear that the corporate sector will be forced to retrench if banks are unable to extend financing for expansion. The result has been a flight from those cyclical sectors, such as construction, retailing and financial stocks in favour of food, utilities and healthcare. The relative share price changes between these sectors just in the month of November have been dramatic, belying the modest 4.0% fall in the FTSE 100 index. Some stocks particularly exposed to the consumer cycle fell by as much as 15% over the month.

UK Interest Rate Dilemma

The bank of England is now in a conundrum over interest rate policy. Inflation has risen to 2.1%, slightly above the Bank's target of 2.0%, as commodity prices, especially food, have risen sharply. The direction for inflation in the short term appears to be up, evidenced by the uncomfortably high 3.5% rate in the US and 3.0% in the Eurozone. This points to little change in interest rates. However, if the economy is about to tip into a consumer led downturn, then the Bank should be following the US Federal Reserve's lead and cutting interest rates by more than the 0.25% just announced.

Total Returns in Local Currency

Last month and last 12 months

		Total Return for Market 1 month to 30 Nov %	Total Return for Market 12 months to 30 Nov %
Currencies v £	Rate		
US dollar	2.06	1.2	-5.4
Euro	1.41	2.2	5.3
Yen	229	4.9	-1.0
Cash (3m)	Yield %		
USA	4.94	0.4	5.3
UK	6.51	0.5	5.2
Euro	4.73	0.4	3.7
Japan	0.86	0.1	0.5
Bonds (10yr)	Yield %		
USA	3.95	4.6	8.7
UK	4.69	2.8	3.2
Germany	4.16	1.4	0.0
Japan	1.48	1.3	3.3
Equities	Index		
USA	S&P Comp	-4.2	5.7
UK	FTSE 100	-4.0	10.0
Germany	DAX	-1.7	24.7
France	CAC	-2.8	9.1
Spain	SMSI	-0.7	15.1
Italy	BCI Gen	-3.8	1.1
Japan	Topix	-5.3	-3.3
Australia	All Ord	-2.4	25.6
Hong Kong	Hang Seng	-8.5	54.1
Alternatives	Index		
Property	IPD	-1.5	1.8
Commodities	DJ AIG	-3.1	6.0
Hedge Funds	HFR	-3.5	6.3

Source: Reuters

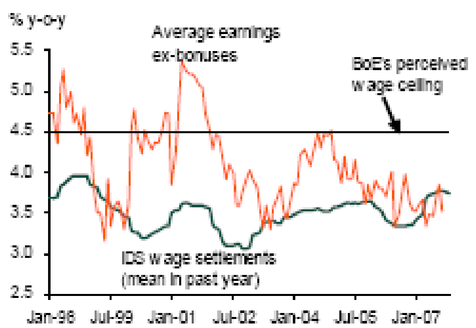
December 2007

Movements in the US and UK financial markets indicate there is a real fear of impending recession. The yield on the 10 year UK gilt has fallen by 1.0% since July and by 0.3% in the month of November, in spite of evidence that inflation is rising. Corporate bond yields have not fallen as much, underperforming gilts as investors have sought the safety of gilts rather than higher returns. The rush out of cyclical shares expresses the same concern.

How Weak is the Economy?

The evidence to support these worries, however, is in short supply. Certainly the US housing market is in recession and in the UK house prices have fallen by 2.4%

UK Personal Earnings Support Consumer Spending



Source: ONS, Datastream, Lehman Brothers Global Economics.

over the past three months. However, unemployment in the UK remains stable at only 5.4%, earnings growth is healthy at 3.8% and consumer spending is holding up, with November sales 3.1% higher than a year ago and expectations that Christmas will see 5% growth over 2006. Manufacturing activity has also risen as exports to Europe have boomed, thanks to a weaker sterling vs the euro exchange rate and strong growth in Germany.

A slowdown in the economy is underway, but with the help of further interest rate cuts in the first half of next year, we expect that the UK economy will grow by close to 2.0% in 2008, in line with the recent OECD forecast.

Fears for the UK banking sector also appear to have been overstated. Barclays, HSBC and RBS have all reassured over the scale of their subprime wite-offs and indicated that earnings for this year will be in line with or better than expectations. With dividend yields of 8.0%, price / earnings ratios half that of the market and earnings growth of 10% expected over the next two years, we believe there is attractive value in the financial sector.

Japan Outperforms

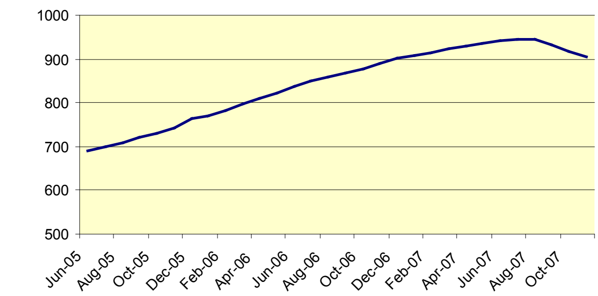
Our recent reduction in Pacific Basin equities in favour of Japan has proven timely, as Hong Kong proved to be the weakest market in November. The 4.9% appreciation in the yen over the month enhanced the return on Japanese equities, making Japan one of the best performing markets for a sterling investor.

Commercial Property Weakens

With rental yields at historic lows of 4.7%, whilst short term interest rates are at 6.5%, the commercial property market has been vulnerable to a downturn for some months. Retail investors are now selling and the trend in the IPD property index has recently turned down after 15 years of rises. We expect UK property values to be revised downwards further as investment funds are forced to sell at distressed levels. We have therefore sold our holding in the Norwich Property Trust with a view to reinvesting in a global property real estate investment trust.

Matthew Hunt

IPD Comercial Property Index
June 2005 to November 2007



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