



Summary

- **Global economic growth is slowing but only the US appears to be facing possible recession .**
- **Policy response has matched the downturn - 1.25% cut in US interest rates, 0.25% in UK, more to come.**
- **Company earnings are being revised down - further revisions likely but the process is well advanced.**
- **Bond valuations are not compelling and do not offer an attractive alternative to equities.**

A Weak Month for Equities

January saw equity markets reach new lows for this cycle. This may have had more to do with Societe Generale unwinding huge stock positions established by a rogue trader than the underlying economic news. It was not surprising, therefore, that equity markets bounced following two interest rate cuts totalling 1.25% by the US central bank and some reassuring news on US economic growth in the second half of the month. Although the US and UK equity markets ended up 5% from their lows, all equity markets showed sizeable declines over the month.

Hong Kong proved to be the worst performer, vindicating our view that the overvalued Asian markets would not be immune to global economic slowdown and its implications for equities. The US market was the best performer, thanks to the willingness of the authorities to cut interest rates rapidly and a commitment from the government to reduce taxes to produce a meaningful stimulus to the economy in 2008. Our decision to reduce our Asian exposure in favour of the US in early January thus proved timely. In Europe, by contrast, where the central bank has resisted making interest rate cuts, equity markets suffered double digit declines, in spite of an economic backdrop that is seen to be more robust than that of the US or the UK.

The UK bond market produced positive returns but lagged the performance of the US and European bond markets. Worries that inflation will rise in coming months due to food and energy price increases meant that UK bond yields were little changed over the month.

Credit Crisis Creates Uncertainty

The high volatility of financial markets over the past six months reflects the uncertainty over the likely impact of the credit crisis on the wider economy. There is no doubt that banks are being more cautious in their lending to companies

and to the consumer. Does this represent a long overdue return to sensible lending practices or is this the harbinger of recession? Globally, the economic news over the past month has been mixed, though on balance it is clear that growth is slowing. In the US, the service sector appears to be suffering, with one indicator plunging suddenly to a level last seen in

Total Returns in Local Currency

Last month and last 12 months

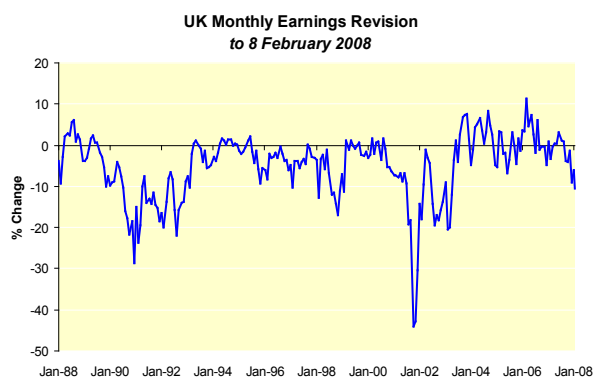
		Total Return for Market 1 month to 31 Jan %	12 months to 31 Jan %
Currencies v £	Rate		
US dollar	1.99	-0.1	-1.2
Euro	1.34	1.8	13.3
Yen	211	4.6	12.9
Cash (3m)	Yield %		
USA	3.06	0.4	5.4
UK	5.47	0.5	5.6
Euro	4.24	0.4	3.8
Japan	0.79	0.1	0.4
Bonds (10yr)	Yield %		
USA	3.60	4.0	15.5
UK	4.53	0.7	8.7
Germany	3.93	3.6	5.5
Japan	1.45	0.7	4.1
Equities	Index		
USA	S&P Comp	-5.9	-4.2
UK	FTSE 100	-8.9	-1.9
Germany	DAX	-14.9	2.9
France	CAC	-13.0	-10.7
Spain	SMSI	-12.3	-8.3
Italy	BCI Gen	-11.0	-14.5
Japan	Topix	-8.6	-20.7
Australia	All Ord	-10.9	3.6
Hong Kong	Hang Seng	-15.5	19.6
Alternatives	Index		
Property	IPD	-3.7	-9.6
Commodities	DJ AIG	4.2	20.9
Hedge Funds	HFR	-2.5	1.4

Source: Reuters

the recession of 2001. Other evidence is more reassuring and the bad news is at least partly offset by the scale of the policy response. We expect US interest rates to be cut by another 0.5% to 2.5% in the next month, meaning that real interest rates (i.e. after inflation) will be negative, at -1.5%, which is highly stimulative for the economy.

In the UK, the economic news has generally been better than expected, with most sectors expanding, though at a slower pace than last year. The fact that the Bank of England recently only cut interest rates by 0.25%, leaving real rates at a restrictive 3.1%, shows that their concern is more with inflation than with growth at the moment.

Company Earnings Revised Down



Source: Lehman Bros.

The chart above shows why the UK stock market has fallen over the past month. Analysts are rapidly lowering their expectations for future company earnings growth, a pattern that is being repeated in all the major equity markets. This process probably has further to go, but some sectors, such as banking and general retail have already been marked down to reflect recession levels of earnings. It is noticeable that these sectors are now proving resilient to further market declines. The turning point in the market is usually associated with a bottom in earnings revisions, so we monitor this indicator with particular interest.

In the meantime, market valuations are much more attractive than is typical at this stage of the earnings cycle. On the basis of current earnings forecasts, the price /

earnings ratio for the market is only 12 times, below the long term average of 13 times. This provides support for equities, despite the risks to earnings and to the wider economy.

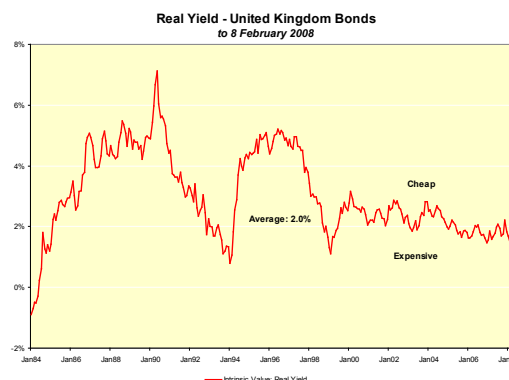
Nevertheless, these risks should not be underestimated. Banks are still not able to sell, or “securitise”, mortgages to longer term investors to free up capital, in the way that they have in the past. If this persists, the credit crisis will only go from bad to worse, threatening the mortgage banks such as HBOS. Already the UK Treasury is looking at possibly offering a government guarantee to certain categories of mortgage securitisation, as happens in the US, to restore confidence. We would expect that the worst case outcome will thus be avoided.

Bond Market Value is Low

Whilst equity investors are understandably nervous about the future, there are no compellingly attractive alternatives right now. Bonds, as the chart below shows, are hardly cheap at the moment and are exposed to the risk of higher inflation in the coming months. With UK short term interest rates likely to fall to 4.5% by the end of this year, cash returns are not very attractive either.

In this environment, broad diversification and a focus on undervalued markets and companies offers protection in the short term and opportunity when recovery arrives.

Matthew Hunt



Source: Valu-Trac

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