

Summary

- **Hedge fund collapses lead to a rise in corporate bond yields and weaker equity markets.**
- **We expect this latest phase in the credit crisis to be contained by the response from central banks.**
- **The US is likely to suffer negative growth in the first half of this year, but should grow 1.0% in the full year.**
- **Equity markets are becoming oversold on several measure of value. We are alert to the opportunity.**

Renewed Tensions in Credit Markets

Over the last month, declines in prices of mortgage backed bonds forced several highly leveraged hedge funds to sell bond holdings to repay their borrowings. One UK fund, Peloton, with \$3.5bn of assets, was forced to liquidate everything. The ensuing firesale has seen yields on some sectors of the bond market (not those in our portfolios) rise to extraordinary levels, with some investment grade bank bonds rising to yields of 10%, twice that of a 10 year maturity gilt. The knock-on effect is that once again short term bank interest rates have risen in the UK as banks stopped lending to one another for fear of who might end up carrying the hedge fund losses. In the US, where similar problems arose, the central bank has made additional funding available to banks and indicated that official interest rates will again be cut this month. The Bank of England, true to recent form, did not cut interest rates this month and is letting the market work through this latest crisis.

The result was a rise in gilt prices as investors sought the safe haven of government bonds and a further underperformance of the financial sector of the UK equity market. Even though the banks all announced respectable earnings for 2007, with increased dividends pointing to confidence for the future, bank share prices have fallen to new lows for this cycle during the last month. The obstacles to recovery are progressively being overcome, however. The large US banks have received inflows of new capital and the bond insurance companies have been rescued. Low, and falling, short term interest rates now underpin the banking sector. We have even seen some upgrades to expected earnings in the financial sector, following the most recent results.

Commodity Prices Jump

The other feature of February was a sharp rise in commodity prices. Oil rose 13% to a record high of \$105 / barrel, copper rose 18% and wheat continued a rise that has

totalled 126% over the past 12 months. These moves reflect a perception that emerging market demand for energy and metals will continue to place pressure on supply, which is not growing at the rate previously expected. Whether these perceptions will change again, as global economic slowdown reduces demand, remains to be seen - most likely

Total Returns in Local Currency

Last month and last 12 months

		Total Return for Market	
		1 month to 29 Feb %	12 months to 29 Feb %
Currencies v £	Rate		
US dollar	1.99	0.0	-1.2
Euro	1.31	2.1	13.4
Yen	206	2.4	12.7
Cash (3m)	Yield %		
USA	2.84	0.2	5.4
UK	5.66	0.4	5.5
Euro	4.29	0.3	3.8
Japan	0.91	0.1	0.7
Bonds (10yr)	Yield %		
USA	3.52	0.9	13.5
UK	4.47	0.9	7.5
Germany	3.87	0.8	4.8
Japan	1.36	1.0	4.2
Equities	Index		
USA	S&P Comp	-3.3	-3.2
UK	FTSE 100	0.9	-1.3
Germany	DAX	-1.3	3.3
France	CAC	-1.3	-10.3
Spain	SMSI	-0.4	-7.1
Italy	BCI Gen	-0.8	-13.3
Japan	Topix	-1.5	-23.4
Australia	All Ord	0.0	2.3
Hong Kong	Hang Seng	3.9	26.8
Alternatives	Index		
Property	IPD	-1.6	-9.7
Commodities	DJ AIG	12.3	31.3
Hedge Funds	HFR	3.7	6.1

Source: Reuters

March 2008

they will. We expect that wheat prices are likely to fall in April thanks to a bumper winter crop and higher acreage under cultivation in 2008/09.

Economic News Mixed

We now expect that the US will suffer a protracted, though mild, slowdown. Employment has declined over the past two months and consumer and business confidence are at recessionary levels. However, a low level of unemployment has kept consumer spending growing and the weak dollar has promoted strong export growth. Whilst the first two quarters of this year are likely to see negative growth, we still expect the US economy to grow by 1.0 - 1.5% over the full year.

Retail Price Inflation Expected to Fall in 2008



RPI - Retail Price index, CPI - Consumer Price Index
Source: Lehman Brothers

The UK economy has shown considerable resilience in the face of high real interest rates and the credit turmoil. Manufacturing is still expanding, helped by the weakness of sterling against the euro and yen. Consumer spending is also growing, though this partly reflects the higher price of goods as the rising cost of energy and commodities feeds through to prices.

A New Era of Stagflation?

Headline inflation in the UK (and elsewhere) is rising at a rate well above central bank's target of 2%, thanks to commodity price rises (see the chart above). However, there is little evidence that inflation expectations are rising. Index linked bond yields are close to all time lows

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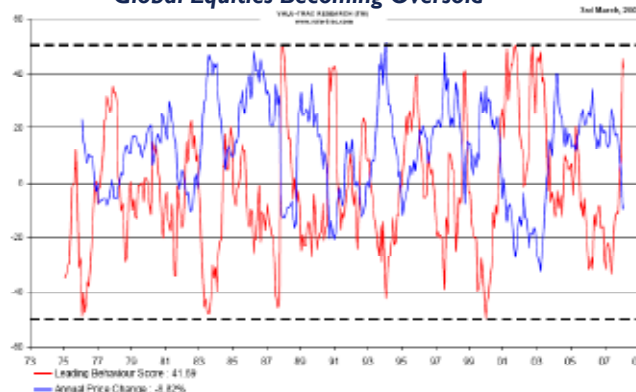
and core inflation (ex food and energy) is only 1.3%, as wage growth has been stable at 3.5% - 4.0%. We expect this will reassure the Bank of England that the rise in inflation is a temporary phenomenon, leading to a cut in UK interest rates to 5.0% in May.

Equity Sell-off Becoming Stretched

The recent sell-off in global equity markets has meant that equities generally are starting to look attractive from several valuation perspectives. The chart below combines three leading indicators of value: cash flow yield, margin of safety and the equity earnings yield relative to bonds. It is evident that previous buying opportunities (1987, 1990, 1998, 2002) have occurred when the red line is at or close to the extreme of +50. Whilst it may yet be too early to overweight equities, as company earnings in general are still being downgraded, it is clear that value is returning to global equity markets. We are alert to the developing opportunity that is likely to arise in the coming months to buy equities at attractive levels.

Matthew Hunt

Global Equities Becoming Oversold



Source: Valu-Trac



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