

## Summary

- **US rate cuts appear to be underpinning economic growth and averting a US recession.**
- **Reported inflation remains high, but bond markets anticipate lower inflation in coming months.**
- **Global stock markets rally on better economic news and better than expected company earnings.**
- **The environment for bonds and equities remains fragile and we await confirmation the worst is over.**

## Positive News from the US

The reduction in US interest rates from 5.25% to 2.0% over the past seven months and the imaginative efforts by the US Federal Reserve to provide liquidity to the banks appears to be paying off. The latest data shows the rate of decline in US employment has slowed and the unemployment rate actually fell in April. Far from the US falling into recession in the first quarter, as had been feared, the economy actually grew by 2.4% annualised. Admittedly, part of the growth is explained by a build-up of inventories, which may lead to negative growth in this quarter. However, the prospect of recession (two quarters of negative growth) appears to be receding. This means that the latest cut in short term interest rates, on April 30th, may be the last for a while. This could even turn out to be the low point for this cycle.

US inflation is still running at a high 4.0%, but US bond yields only rose modestly (0.3%) in April from the lows reached in the previous month. Clearly, the market expects that below trend growth in the economy over the next 12 months will bring inflation back down, in spite of the recent rise in food and energy prices.

## Global Equity Markets Rally

The renewed optimism over the US economy has been a powerful catalyst for a turnaround in equities, corporate bonds and the US dollar. As the table shows, all the major equity markets rallied over the month, with the recovery continuing in May. The best performing markets were Japan, where we are overweight, and the Pacific Basin, where we are underweight. Whilst there is clearly a new mood of optimism, the environment for all asset classes remains fragile.

Corporate bond yields in the US and the UK fell from the extreme levels relative to government bonds that they had reached in March. For example, AIG, the largest insurance company in the world, offered a bond yield some 1% more

than government bonds prior to the credit crisis last year. In March, this "spread" had widened to more than 3%, producing a loss of around 10% on a 10 year bond. Now the difference is down to 2% and we have recently used this improving trend to buy AIG bonds at the still elevated current yields.

## Total Returns in Local Currency

*Last month and last 12 months*

		Total Return for Market	
		1 month to 30 Apr %	12 months to 30 Apr %
Currencies v £	Rate		
US dollar	1.99	-0.2	0.6
Euro	1.27	-1.2	15.2
Yen	206	-4.1	15.7
Cash (3m)	Yield %		
USA	2.85	0.2	5.3
UK	5.63	0.5	5.7
Euro	4.76	0.4	4.0
Japan	0.92	0.1	0.7
Bonds (10yr)	Yield %		
USA	3.73	-2.3	12.1
UK	4.67	-2.2	8.0
Germany	4.12	-1.4	4.5
Japan	1.63	-3.1	1.7
Equities	Index		
USA	S&P Comp	5.0	-4.4
UK	FTSE 100	7.1	-2.1
Germany	DAX	6.6	-3.6
France	CAC	6.4	-13.4
Spain	SMSI	3.5	-4.1
Italy	BCI Gen	7.8	-17.3
Japan	Topix	12.2	-19.0
Australia	All Ord	5.0	-3.6
Hong Kong	Hang Seng	13.0	29.8
Alternatives	Index		
Property	IPD	-0.8	-12.0
Commodities	DJ AIG	3.6	24.7
Hedge Funds	HFR	1.0	1.2

Source: Reuters

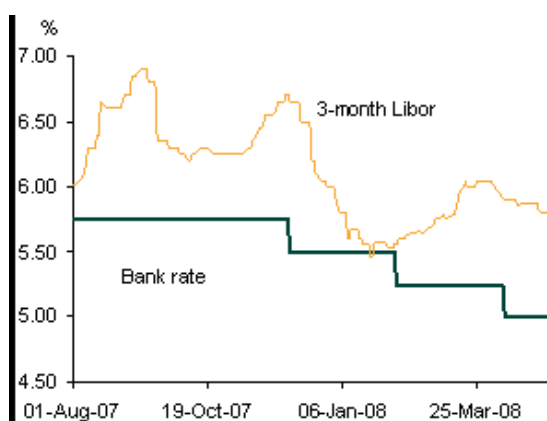
May 2008

## UK Economic News less Positive

UK equities have performed strongly despite economic news that has been markedly less favourable than that of the US.

The reticence of the Bank of England to cut interest rates is starting to be felt by the consumer, with confidence now at the lowest level since 1992 and spending slowing. The housing market is suffering, with house prices down some 5% from their highs and loans for home purchase at an all-time low in March. The slowdown in consumer demand has yet to impact on unemployment, partly because the export sector remains strong, helped by the 14% depreciation in sterling against the euro in the past six months. It can only be a matter of time, though,

### Market Rates Remain High vs Bank Base Rate



Source: Lehman Brothers

before the slowdown becomes more widespread and the Bank of England cuts interest rates further. As the chart above shows, even though official base rates have been cut to 5.0%, the actual rates banks lend at are still high at 5.8%. This helps the banks to rebuild their balance sheets but does little for the wider economy.

## A New Bull Market in Equities?

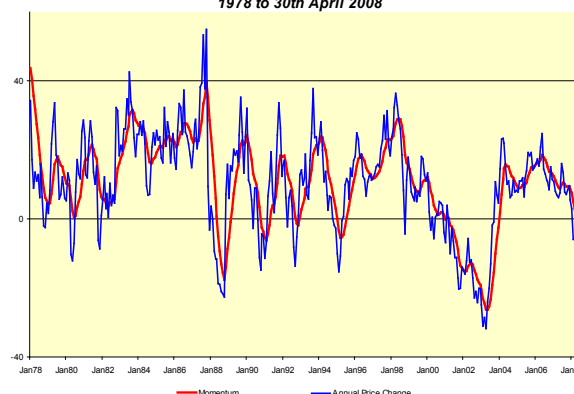
This economic background hardly seems auspicious for UK equities, particularly as the recent rally has been driven largely by the mining and energy sectors, which now appear vulnerable to a correction in commodity prices. On a more positive note, though, reported

company earnings, excluding the banks, have been better than expected, leaving valuations for the cyclical companies at attractive levels. If a recovery in the US economy averts recession, the retail, media and financial sectors will benefit. This month we have seen a bid for the media company Taylor Nelson, as the low valuation of the shares attracted a takeover from WPP. Longer term investors see current valuations as an opportunity to buy cheap assets.

In March we highlighted that equities looked oversold. Whilst we have seen a significant rally since then, we have yet to see momentum turn up in a sign that we are entering a sustainable upward trend in equities (see the chart below). For the moment, we remain cautious, but if we see the signs that the real economy can shrug off the effects of weaker property prices and tighter credit, we will raise our exposure to equities at the expense of bonds.

### Matthew Hunt

#### Equity Price Momentum - United Kingdom 1978 to 30th April 2008



Source:Valu-Trac

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